Developments Abroad and the Domestic Economy

1

Ontario Economic Council

Developments Abroad and the Domestic Economy

ONTARIO ECONOMIC COUNCIL
SPECIAL RESEARCH REPORT

VOLUME 1

ONTARIO ECONOMIC COUNCIL
81 Wellesley Street East
Toronto, Ontario
M4Y 1H6

Printed in Canada

ISSN 0225-591X
ISBN-0-7743-5549-2 √

These papers reflect the views of the authors and not necessarily those of the Ontario Economic Council. The Council establishes policy questions to be investigated and commissions research projects, but it does not influence the conclusions or recommendations of authors. The decision to sponsor publication of these papers was based on their competence and relevance to public policy.

The papers in these two volumes were presented at a conference entitled 'Developments Abroad and the Domestic Economy.' Each main paper was the subject of a session and was followed by prepared comments and by discussion from the floor. The conference, which was held on 3-4 June 1980, was sponsored by the Ontario Economic Council.

Contents

Volume 1

Volume 2

Canada in the North American trading economy

Rodney de C. Grey

This paper is a précis or summary of an extended study that I hope to publish of trade policy for Canada. For that reason, the argument is set out in a rather summary form.

My purpose is to try to identify the problems and the possibilities that will face Canada in evolving policy to guide our detailed trade policy relationship with the United States. I would like to offer some suggestions, both as to procedure and as to substance, about how we Canadians might go about working out solutions to the problems in trade relations that will develop in the 1980s between Canada and the United States. I hope the argument is accepted that, given that 70 per cent of Canada's trade is with the United States, it is not unreasonable to focus on the problems of trade here in North America and to put aside, for the purposes of getting to grips with trade policy, those issues that relate to others overseas - to Japan, to Europe, to the developing countries - where our trade and our trade prospects are so much less important than is our trade with the United States.

I should like to begin by stating some working assumptions and propositions, the truth of which and indeed the relevance of which I hope are self-evident.

My first proposition is that for a small country surrounded by larger countries and heavily dependent on trade with one of them, foreign policy - that is, the policy for conducting relationships with other states, for fixing our role vis-à-vis other states - ought in large part to be trade policy. Of course, there are other policy issues, but if we dissipate our foreign policy credit on issues that concern us primarily as a member of the international community, we may not have the energy or the resources to protect the trade interests of Canadians.

Canadian businessmen are aware that businessmen in other countries -

in France and in Japan, for example - receive co-ordinated and organized support from their governments in their trade initiatives. Such a combination of business and government could be termed France Inc., or Japan Inc. Canadian traders are quite right to ask for the same degree of determined support from their governments, particularly when they have to compete with others who do have that sort of support. Their request for more trade policy content in foreign policy is all the more justified by Canada's relative lack of raw power - as compared to the United States, to Japan, and to the EEC - and by our dependence on selling a narrow range of products, largely to one market. In summary, as I see it, foreign policy for Canadians ought in good part to be trade policy.

The reason that foreign policy discussion and the foreign policy milieu in Canada is so preoccupied, so taken up with other issues, is that we have imported the agenda of foreign policy, the issues for foreign policy discussion, from the United States. Why should we assume that the foreign policy perceptions of a country that is twelve or fourteen times more powerful than Canada, with world-wide interests and global responsibilities and relatively much less dependent on trade, would be the right perceptions for Canada? In the United States trade policy in general is seen as an instrument of foreign policy. That was true when President Roosevelt and Cordell Hull launched the Reciprocal Trade Agreements Program as an instrument of the 'Good Neighbour Policy', and it was equally true when President Kennedy persuaded Congress to legislate a mandate for the Kennedy Round of negotiations - that was part of the 'Grand Design' for strengthening Western Europe and the 'alliance.'

Of course, all this is a question of balance and emphasis. But that is my point: the American emphasis and the American balancing of the various policy elements ought not to be uncritically imported and adopted in Canada.

My second proposition has to do with method. Much of the discussion of trade policy in Canada has proceeded from a teaching model intended to drive home the point that, in general, trade does increase welfare, and that to be able to realize a comparative advantage when you have one is, comparatively, an advantage. It has proceeded from that necessary teaching aid to a set of propositions that 'free trade' would be a good thing, particularly for Canada, and that therefore we ought to do something about our tariffs. Sometimes Canadian discussion on trade policy

has been no more than importing the rhetoric of American argument that has been developed in the recurrent internal American debate over trade policy legislation, and which has thus been addressed primarily to other Americans, and taking it as gospel in Canada. Sometimes this process has been no more than accepting as revealed truth some purely self-serving attack by American (or EEC, or Japanese) exporters on what commercial policy we have. The discussion has been quite misleading, primarily because it has been almost entirely about tariffs, and not sufficiently about other devices that governments use to intervene at the border or otherwise to regulate the competition between domestic production and imports. To propose the removal of tariffs, and to create a tariff-free zone, is a specific proposition, well worth discussing on its merits. To propose real 'free trade' is to propose something much more complicated, much more difficult, perhaps not even possible, to achieve. We do not have 'free trade' within Canada, even though Canada was founded as a customs union; there are a significant number of barriers to the free movement of goods within Canada.

My working assumption is that we should take the lesson that trade is a good thing as a lesson learned, and then address the problems of the real world. What are the various barriers to trade here in North America? Who gains and who loses by the use of which particular device? What price will we pay and what will we gain if we try to negotiate away some barrier or bring its use under agreed control?

My third working assumption is a challenge to an assumption that is too frequently made in Ottawa. It is quite often assumed that the best way to work out our trade policy problems with the United States is <u>multilaterally</u>. It is argued that, as a practical matter, the only way we can get U.S. tariffs down is by putting together the bargaining power of other GATT countries. That is sometimes the case: the Tokyo Round agreement on the civil aircraft sector is an example. But this assumption generalizes too much on the basis of past tariff negotiations; in the negotiations about other barriers or devices it is less likely to be true. It may be, I put it no stronger than that, that for certain matters, such as procurement barriers or even certain high tariffs like those insisted upon by the United States for petrochemicals, we can do more, do better bilaterally. Other examples: I do not believe we should assume we could not have made much more sensible arrangements on countervail and on

customs valuation here in North America than emerged from the multilateral process. Indeed, those agreements, as sets of rules designed to reduce the distorting effects of these two devices, have serious shortcomings, which owe their origin to the fact that the United States was negotiating multilaterally, primarily with the EEC and Japan, and looking to generalized solutions. These inevitably served Canadian interests less well than solutions one could evolve were one dealing in North American terms only.

The Canada/United States Automotive Products Agreement was of course, a conspicious and very complicated example of going further bilaterally than was possible multilaterally. As an agreement it was peculiar to that time and that sector. It demonstrated, however, that bilateral solutions to trade policy problems can yield substantial results.

My assumption is, therefore, that we should now look for solutions to trade policy problems with the United States that would be negotiated bilaterally. Perhaps, for some issues, there is no acceptable bilateral solution - or perhaps the bilateral price will be high. For others there may be a bilateral solution that is not necessarily second-best. Whether or not the bilateral-negotiation arrangements are extended to others on a most-favoured-nation basis or on some basis of reciprocity is a question to be decided issue-by issue, case-by case.

To summarize: my working assumptions are: that trade policy should have high priority in our foreign policy, and our policy towards the United States should have a large trade policy component; that the trade policy debate is not a debate about 'free trade,' certainly not now, if it ever was, but rather about the costs and benefits of making trade freer by regulating the trade-regulating instruments; that we must not assume that multilaterally negotiated solutions or multilateral solutions are the only or best solutions to trade problems between Canada and the United States.

I shall now describe where we are in trade relations with the United States and then list some issues that are now unresolved, and that may become more important in the 1980s, and then suggest how we might go about solving them. To begin, we should summarize what came out of the Tokyo Round.

First: the fact that negotiations were in prospect and then in process was a stabilizing factor in trade relations between Canada and the United States. The Tokyo Round, as a negotiating process, lasted from

before the Tokyo Meeting of Ministers that endorsed the statement of principles and a plan for the negotiation in 1973 to the signing of the Tariff Protocol in July 1979. Well before the Tokyo meeting there were important multilateral meetings and there were informal discussions with senior U.S. representatives in which Canadians were able to say what they would like to see in the United States negotiating mandate. Thus for a very long period - not quite a decade - the fact that we were planning negotiations, and then that we were negotiating, that there was on-going bilateral and multilateral discussion, that there was a working apparatus, in Geneva, in Washington, and eventually in Ottawa, designed to deal in a context of practical problem-solving with at least some of the emerging problems - all this was part of the trade policy environment. It was a major element in the management of our trade relations with Washington for most of the 1970s.

That pervasive influence on the conduct of trade policy is no longer there. (I do not detect any great enthusiasm for launching another broad multilateral negotiation, although some spokesmen of the service industries - banking, insurance, computer services, engineering - are eager to explore the possibility of developing GATT-like rules for services.)

Secondly: the style, the modalities, of how we dealt with the range of non-tariff issues in the Tokyo Round will be an element in trade policy relations for the foreseeable future. Leaving the tariff rate negotiations to one side, the Tokyo Round Agreements are set out in detailed, legalistic, complicated, and sometimes ambiguous language. They are supposed to be contracts; they are supposed to embody what the negotiators were prepared to say, issue by issue, was an adequate balance of rights and obligations. But the style of these agreements both reflects and stimulates the trend to a rather legalistic trade policy apparatus in the United States and, of course, in Canada. This trend to detailed legalism as the style of trade policy started well before the Tokyo Round. The codes worked out in Geneva not only sanction that approach: they make it obligatory.

A third point about the Tokyo Round outcome: one of the key concepts, one of the accepted elements, of the trade policy system, from the Havana Conference to the Kennedy Round, was that the tariff was to be the central instrument by which the governments of advanced industrial countries intervened to regulate the flow of imports. The Kennedy Round, one could say, signalled the switch, in the United States obviously, in

Canada less obviously, from a tariff-centred commercial policy system to what I have called elsewhere a system of 'contingent protection'. We have moved away from a system in which, except for agriculture and except for emergencies (and except, of course, for textiles and clothing), domestic producers were given protection by the structure of tariff rates to a system in which producers get protection when they can make a case for it - against dumping, against subsidized imports, and against sudden surges of imports that they can argue should not be tolerated.

A fourth point about the Tokyo Round results: there is a lot of unfinished business. For example, and it is a major example; the procurement code doesn't cover very much procurement. It relates only to major purchases of civilian goods by departments of a central government. It does not cover purchases by provincial governments or by state governments, nor does it cover purchases by those agencies that buy the sort of product that Canadians (particularly in Ontario and Quebec) can design and produce economically and could export: heavy electrical generating equipment, telecommunications equipment, railway and mass transportation equipment. Indeed, while the Tokyo Round was in progress, and despite the negotiating objectives embodies in the Trade Act of 1974, Congress legislated additional and onerous 'Buy American' provisions in the United States. That issue should stay on the agenda.

Our failure to really open government procurement to import competition same basis as private commercial transactions is probably something of a relief to firms that now profit from procurement preferences in Canada (in addition to existing tariff protection). In my view this ought to be a disappointment to those many Canadian producers who could compete over existing or potentially lowered tariffs in the United States procurement market if we were to negotiate away the forest of 'Buy American' provisions.

There are other examples: we could not agree on new rules on emergency or 'safeguard' action against 'fair' but politically intolerable import competition. We had a long, rather bitter, five-year debate - first, about 'selectivity' (fancy word for discrimination) and then about 'surveillance' (the degree and timing of collective scrutiny of 'safeguard' actions), and we left the issue more confused than when we started, and the Canadian interest in an effective multilateral system less well protected.

Trade in agricultural products was left in large part unregulated, and, at best, only a little more subject to effective rules than it was before the Tokyo Round. In particular, there was little, if any, progress in devising better rules to prevent excessive, and therefore disruptive and trade distorting, subsidization of agricultural exports. Indeed it can be argued that the revision of GATT Article XVI as set out in the relevant paragraphs of the Subsidies - Countervail Code will perhaps make for even less control over the Community's so-called export restitutions on agricultural exports, which have caused so many problems for the United States, for Canada, and for Australia in regard to competition in markets such as Japan, South East Asia, and Sri Lanka.

Again, the negotiations failed to deal in any significant or effective fashion with the problems of distortion, in terms of industrial location, facing small countries such as Canada that are heavily dependent on resource-based exports and that could reasonably expect the major industrial countries to allow them to upgrade their exports. This was the thrust of the Canadian 'sector approach.' It is important to note that the United States was much more receptive than was the EEC, the Nordics or Japan, to the substance of the Canadian proposals regarding the 'sector' technique of negotiating, although they did not endorse that techniques as such except in relation to the problems in the trade in civil aircraft. Clearly, for resource-based products, the sector approach is an idea whose time has not come.

One of the useful results of Canada's having advanced this proposal was that it provided a respectable, coherent intellectual basis for refusing to agree on any rules regarding export taxes and export restrictions. One can argue that the GATT ought to be completed by the articulation of rules in this area - and the resource importers will no doubt continue to so argue - but, as Fred Bergsten long ago pointed out, the obverse of such new rules must be better terms of access for processed resource-based products. The idea of completing the GATT by rules governing exports is, like the Canadian sector proposals, an idea whose time has not come.

There are also some important tariff problems left over from the tariff-cutting component of the Tokyo Round. The most obvious, from a Canadian point of view, is in petrochemicals. There were a lot of reasons why so little progress was made: EEC concern about Eastern European

petrochemical capacity; potential excess capacity in petrochemical facilities in the Gulf, with the threat of 'rogue' cargoes looking for markets; the traditional addiction to high tariff protection of the United States industry.

There has been some confused reporting about Canadian objectives in this area. For the record, I should like to say that I had received written authority to seek much lower tariff rates in the United States than Robert Strauss was prepared to accept, that I was authorized by the ministers to match lower United States rates product by product, and that this negotiating position was cleared in detail with senior spokesmen for the Canadian industry and for the Government of Alberta. The American commentator who has suggested that the reason for the failure in this area was that Canadians were confused about their objectives is not correct, as far as the respresentatives of Canada were concerned, although no doubt United States industry representatives received and relayed all sorts of confusing signals. In any event, here is another item on the agenda of unfinished business between Canada and the United States.

Now we have reached the stage of implementing the Tokyo Round results in detail. The United States is, of course, very much further along in that process; it has new, highly detailed legislation, and it has revamped the administrative apparatus. For Canada, all this is ahead of us. When the proposals for a new valuation system,[1] for a revised and more detailed anti-dumping system, and for a full-blown countervailing duties system are made public, as is expected they will be shortly,[2] it will become evident that there will be difficult issues for Canadian ministers, administrators, and businessmen, let alone for the legal craftsmen, as we try to adjust our legislation and our administrative system to our new obligations and to the new pressures to less exclusively on tariffs, and more on the various complex forms and interrelated mechanisms of 'stand-by' protection.

What will be the pressures, what will be the issues, what will be the content of trade policy relations of the 1980s between Canada and the United States? I should like to set out a series of issues, some of which I

1 These proposals were published and referred to the Tariff Board on 29 August 1980.

2 These proposals were published in July 1980 by the Department of Finance: Proposals on Import Policy: a discussion paper proposing changes to Canadian import legislation.

have already referred to an unfinished business, and which, it seems to me, will be fairly urgent matters here in North America. This is, of course, not an all-inclusive list.

First, let us consider the anti-dumping duty and countervail duty systems. I think that U.S. producers will seek full recourse to the protective provisions of their new legislation and to their new or rewritten GATT rights, if there is dumping by Canadians or if Canadian exports are subsidized. It remains to be seen just how hgh a threshold of pain the concept of 'material' injury will mean in regard to dumping and subsidization. If it is too low, one can expect quite a lot of cases directed at Canadian exporters. My guess is that Canadians will be rather less willing to use anti-dumping and countervail against U.S. competition. That is not unreasonable, given that we are much more dependent on trade than are Americans.

There are particular problems about countervail. Clearly, with the high cost of capital, with serious regional disparities in incomes and with serious unemployment in certain parts of Canada, there will be a continuing need for both federal and provincial assistance to industrial development in Canada. Obviously much of the resulting production must be exported, and much of it to the United States. Thus a vigorous U.S. countervail system can have a serious impact on the effectiveness of Canada's industrial development programs, although, because the impact will be that companies do not bother to try to establish in Canada, it is difficult to detect and impossible to measure. U.S. subsidization of industry tends to encourage production for the U.S. market, not for export to Canada. Thus our countervail is not going to be a discipline for Americans, merely an irritant. This asymmetry in the impact of countervailing duty actions on the two sides of the border must be addressed fairly quickly.

Asymmetry was always there, of course; when the United States Treasury, on the urging of the American producers, many of whom had accepted subsidies both in the United States and for their subsidiaries in Canada, decided to impose countervailing duties on Michelin tires exported from Nova Scotia, it became painfully clear that had Michelin accepted the same subsidization from a municipality and state in the United States, our countervail on their subsidized exports to Canada would have had very much less effect on their profitability than U.S. countervail had had.

There are some curious results: first, 80 per cent or so of the Federal and Nova Scotia grants to Michelin have accrued to the United States Treasury. Secondly, one begins to wonder if perhaps there is rather more risk of countervail if the Canadian firm concerned is not a subsidiary of the United States parent firm (perhaps the vigour with which the United States Treasury pursued Honeywell in the case involving a PAIT subsidy for the research into and development of a new optic liquid level sensor was designed to show us that we were wrong in making this assumption). Thirdly, it was obvious that virtually any optimum-size plant set up in Canada with an optimum product mix would need to export to the United States. Countervail by the United States therefore could create a pressure to retain tariff protection and to force Canadian plants to rely unduly on the Canadian market: or, alternatively, to redirect potentially Canadian plants to United States locations.

The perverse and unduly damaging effects of United States countervail in relation to regional development grants was recognized by the Treasury during many detailed consultations on Michelin; the Treasury developed the practice of 'offsetting': under this practice only a subsidy in excess of the higher costs involved in locating a plant in a less than prime location in Canada would be considered as being a subsidy. Establishing just what are the net difference in the costs of location in a prime location and in less than a prime location is a difficult exercise, and, clearly, calculating the 'offset' could be a painful exercise of confessing to the Treasury. But it made economic sense, and it took into account the fact that regional economic development grants were instruments of national policy, and not only in Canada. Moreover, this practice would have had the merit of putting a sort of ceiling on Canadian regional programs. For a variety of reasons, this 'offsetting' technique of arriving at a net countervailable subsidy was not pursued to a conclusion in the Michelin case. However, in several cases involving subsidized exports from the EEC, the Treasury did apply this technique.

However, the new Trade Agreements Act, when read in conjunction with the Report of the Senate Finance Committee, which is part of the 'legislative history' and not to be ignored, clearly outlaws this offsetting. Like so many other developments in Congress, it was not aimed at Canada but rather at the EEC. The effect on Canada is obvious; in this area the Tokyo Round has occasioned a major retrograde development, and counter-

vail is potentially a more punitive device than it was before. This is a matter that must be sorted out with Washington.

There may well be difficulties regarding safeguard actions. In a recession and in a period when supplies from new sources (East Asia and the developing countries) are entering our markets, businessmen in both Canada and the United States are likely to seek emergency import protection (that is, if they cannot prove dumping or subsidization, which are clearly much more attractive techniques for securing 'standby' protection). Aside from the cases where Canadian exports to the United States seem intolerable to some U.S. producer, and we cannot rule out that there will be such cases, the main problem will be Canadian exports getting caught up in U.S. safeguard actions generated by imports from other sources. Specialty steel and fasteners are examples of United States emergency actions affecting Canada when Canadian exports were not part of the problem. More recently, there was the case of leather garments, in which Canadian exports were at risk because of the impact on the U.S. market of imports from other sources. The International Trade Commission (ITC) proposed a sharply increased tariff, which would have been very damaging to our exports. Fortunately for Canadian exporters, the president did not accept the ITC's proposal; however, the issue is now being considered in the Congress, can override the president's decision.

This problem of Canadian exports getting caught up in a United States 'escape clause' or safeguard action directed primarily against imports from other sources is, of course, a result of insisting on the non-discriminatory application of measures under GATT Article XIX. It is the price we pay from time to time for insisting that that Article be interpreted as requiring that any action be taken on a non-discriminatory basis, and opposing the EEC's concept of 'selectivity.' It is obviously important that, given this non-discrimination interpretation of this GATT provision, the United States, and of course Canada too, apply meaningful tests when determining whether or not there is 'serious injury' to domestic producers caused by imports. It is only this serious injury that justifies measures of emergency protection under Article XIX.

It is important, too, that the Canadian interest in any such issue be put before the responsible U.S. agency early in the investigative process. This is a function we can properly demand be given priority by Canadian diplomatic representatives. It also requires that Canadian business

organize to defend itself in Washington, to present the Canadian case in detail, just as thoroughly as the case for the American domestic producers will be presented. The case for Canadian exports has to be presented in good time, in all the necessary detail, and taking fully into account the provisions of U.S. law and the relevant precedents. Of course Canadian officials have been doing their part in such matter and will continue to do so, but we should not leave all this to diplomats, and having failed to support them when it matters, expect them to negotiate a better deal after U.S. officials make their recommendation to the president.

Another policy area where there may be difficult issues between Canada and the United States in the 1980s is the area of anti-trust policy. I include anti-trust in the broad scope of trade policy because it is so often about trade and so often affects trade relations. I share the view of Canadian experts on restrictive trade practices legislation that more, though not all, U.S. anti-trust actions over the years have, in their effect on Canada, been benign, or at least neutral. I do not exclude from this description those cases where American trust-busters have tried to extend their jurisdiction into Canadian affairs. A certain extraterritorial reach is characteristic of many activities designed to control restrictive trade practices. However, some U.S. anti-trust actions (not excluding private actions) have involved real differences in policy and perception of national interest between the two administrations. For this reason there have been detailed arrangements worked out for timely consultation of these issues between the two administrations.

Recently there was a bill proposed in the United States Senate, sponsored by Senator Kennedy (the Oil Windfall Acquisition Act), which, if enacted, would have extended the jurisdiction of U.S. law and U.S. courts in a substantive way over the investment plans of the Canadian subsidiaries of U.S. oil companies.

The sponsors of the bill intended that the bill would stop the U.S. oil companies using their resources to acquire foreign energy companies (either their assets, or control) or, even more important, using windfall profits arising from price increases to by non-energy enterprises in the United States or abroad. As the Canadian government stated: the bill 'deliberately and explicitly claims jurisdiction over foreign affiliates, including those incorporated in Canada' and could 'at least hinder and possibly prevent investment in Canada by oil companies in non-energy

sectors (e.g. minerals), downstream energy sector activities (e.g. petro-chemicals), and energy transportation, including oil and gas pipelines even where the Canadian government considered such investment desirable and where funds for the investment were earned in Canada. The proposed legislation with its reverse-onus presumption whereby firms would be expected to show that their activities in Canada are not inconsistent with proposed legislation will, of itself, be a serious disincentive to oil companies' investment decisions in general.'

Although the bill has been amended, it still raises many of these same problems for Canada. It seems fairly clear the restrictions on the acquisition activities of many of Canada's largest oil companies and their American and other foreign affiliates would hamper the efforts of these companies to play their part in the development of Canadian resource supplies.

Supporters of the bill have tried to answer all of the objections to it by pointing to the bill's provision for affirmative defences for 'pro-energy' and 'pro-competitive' mergers. From the Canadian point of view, the pro-competitive defence would be useless because it applies only to acquisitions that substantially enhance competition 'in the domestic or foreign commerce of the United States.' (Emphasis added.) The pro-energy defence would likewise prove of little value; the Judiciary Committee Report implied that its coverage of foreign acquisitions would also be limited to those showing some significant demonstrable benefit to the United States.

More recent reports suggest that there is rather less likelihood of this bill going forward. I have mentioned it because, like many other activities in Washington that bear on Canadian interests, it got very little attention in our press, and thus there has been little possibility of an informed Canadian opinion developing that might have brought about a more vigorous and timely Canadian reaction. I am told that had Canada expressed effective criticism of this bill before it had gathered support, as did the United Kingdom, this additional foreign reaction might well have led to the bill being dropped.

It will be apparent from any detailed examination of this particular proposal that, as shown by many other anti-trust proposals, it is difficult to devise an effective policy to regulate the activities of the United States corporations without reaching beyond U.S. jurisdiction. This is the only

way, it seems, to ensure that U.S. corporations do not avoid U.S. law by acting through their subsidiaries and affiliates in other jurisdictions.

This means that there must be effective consultation in anti-trust matters. In such consultations Canada must have a clear view of Canadian policy objectives and not rest solely on repeated objections to the inevitable attempt of U.S. anti-trust administrators to reach beyond U.S. borders. It also means that in the United States there has to be a greater willingness to take into account the legitimate desires of others to deal with corporations in their jurisdictions according to their own laws and their own competition policies. This is of course, not only a Canadian-U.S. problem; the United Kingdom has recently reacted, by passing protective legislation, to the attempts of U.S. courts to assert jurisdiction in anti-trust cases over individuals and corporations within the United Kingdom's jurisdiction.

As noted above, the proposal examined here appears less likely to be enacted than seemed likely several months ago. It is however, an illustration of how legitimate U.S. anti-trust policy can bear on Canada; moreover, there remains concern in the Congress to assert some control over the use by the oil companies of the funds they will accumulate as a result of oil price increases, and the proposal discussed above, or some variant, may well receive further attention.

It would be so much better if in Canada and the United States we could attempt to deal with the substance of energy policy, rather than having yet another battle of diplomatic notes because of an ill-conceived attempt to assert U.S. jurisdiction over Canadians.

As I have already suggested, procurement is a matter that we only started to deal with in Geneva. The United States has a variety of 'Buy American' provisions, at both the federal and state levels. They were designed to keep out, not Canadian goods, but the products of other major industrial countries overseas whose procurement markets are closed to United States producers. Those overseas markets are also closed to Canadian products.

Canadian producers have been particularly disturbed by the extension of the 'Buy American' concept to urban mass transportation projects. This is an area of production in which Canada (particularly Ontario) has developed some competence and indeed, there is an agreement between Canada and the United States providing for co-operation in the develop-

ment of urban mass transportation technology. As it stands, U.S. policy will do considerable harm to legitimate Canadian industrial development.

One should keep in mind that the Tokyo Round procurement code offers the benefits of better access to those countries that themselves offer better access; the United States has made quite clear in legislation that it will give better access to its procurement market only to those who offer American producers better access to their procurement markets. Thus there would be no great intellectual leap required to think of Canadian-U.S deal on procurement that would be open to others who might want to contract in. What Canadians need is the setting aside of barriers to potential exports to the U.S. procurement market, not a preference against the products of these countries. However, if other countries, such as Japan and the EEC, decide not to contract in, the practical result of a Canadian-U.S. arrangement would be a preference area for procurement transactions. The Japanese and the Europeans might well decide that, for the sort of production at issue, such as heavy electrical generating equipment and mass transportation equipment, they can exploit the United States procurement market by relying on assembly or even manufacturing by subsidiaries or affiliates in the United States, whch will import components and technology from their parent companies and at the same time retain their won infinite preferences for domestic producers in their own domestic markets.

Given the proliferation of discriminatory and preferential arrangements around the EEC directed against U.S. and Canadian exports, I, for one, would have no great objection in principle to dealing with this barrier to potential Canadian exports on a reciprocal rather than a most-favoured-nation basis.

We may also have to haul down the tattered banner of non-discrimination if we are to solve some of the particular product or sector problems left over from our Tokyo Round tariff bilaterals. We did, of course, solve a lot of difficult tariff issues between Canada and the United States, but there is some unfinished business. The most obvious is in petrochemicals, where, as has been noted above, the United States insists on maintaining very high rates of duty.

The United States, by its Tokyo Round decision to maintain high rates for petrochemicals, gives the appearance of being willing to accept Canadian oil and gas but to be unwilling to accept these products when

moderately processed. There are Americans, I am sure, who think that Alberta is so eager for access to the United States petrochemical market, at least for the short term, that they will give commitments about the future supply of oil and gas to secure such access. They were encouraged to think so by the frequent references to the importance of the United States petrochemical market by various Albertans assumed to be speaking for the province or its industry. This presumably raised the price, if there was a price, for lowering United States petrochemical tariffs and played into the hands of those in the United States industry who wanted to save United States bargaining power in this sector for a later bilateral deal with Canada. In any case, whatever the reasons, and no doubt they are complex, for the United States deciding to keep high tariff rates in this sector, I am hopeful that with some imagination we can make an arrangement that allows Alberta's petrochemical industry to compete on legitimate terms in adjacent United States markets.

Another major sector where, as I see it, the Tokyo Round left unfinished business, is the automotive products sector. An adequate examination of the trade policy issues for Canada and the United States in this sector would require a paper as long as this present précis. Accordingly, I will do no more than set out a series of propositions.

(1) It is important to remember the negotiating objective of the Automotive Products Agreement. The Report of Professor Vincent Bladen was addressed to improving the <u>efficiency</u> of the industry. Professor Bladen pointed out that the problem lay primarily with the parts industry: there were too many producers making too many different parts. There were acute and peculiar problems of scale: one factory producing a major component (say, the engine, the automatic transmission, or the differential) should feed four assembly plants. Given this, the size of the Canadian market created particular problems if the existing range of consumer choices was to be allowed to continue. To Bladen's proposals regarding efficiency the Canadian government added the objective of substantial increased production in Canada. These objectives were understood and accepted in Washington. The purpose of the negotiation was to find a policy framework for greater and more economical production in Canada, not necessarily to improve the position of the United States industry. The alternative was that the United States might well apply countervail against

the export-bonusing scheme Canada had in effect at that time, and more important, Canada might impose a regime of quantitative restrictions under Article XIX of the GATT. Policy officials in Washington should recall all this.

(2) Any agreement to reach the objective of greater efficiency and greater production in Canada had to take into account what we called 'institutional barriers' to trade, that is, that the industry was dominated by American-owned vehicle manufacturers who were themselves major parts producers. These corporations were, we assumed, inclined to give less attention to Canadian policy considerations than to U.S. policy considerations, and they were, and remain, subject to official pressure from Washington and subject of course, to the pervasive effect of U.S. legislation.

(3) What Canadian producers, both of vehicles and of parts, required was access on tariff-free terms to the North American market. They did not need, and the Canadian negotiators did not ask for, a tariff-preference against European and Japanese competition in the U.S. market. The decision to meet the Canadian request for duty-free access on a preferential basis was made in Washington and against Canadian advice and was related to considerations of policy in this product area about imports from the EEC.

(4) The agreement was premised on continued growth - in the medium term at least - in the North American market for North American made vehicles. It did not take into account the possibility that an important North American demand for vehicles would be met by offshore suppliers. The agreement assumed that the North American producers would continue to produce the kinds and quantities of vehicles that North Americans would demand.

(5) Much of the detailed mechanics of the agreement, particularly the so-called transitional arrangements and the definition of Canadian content, was designed to protect the independent parts producers in Canada. We understood there would be very considerable restructuring of coroprations and of productive facilities. This radical change in the environment of tariff-rates and content rules could only be managed by the independent parts producers if they had some guarantee of market size and access. What we did not forsee was that the vehicle producers would meet so much of their content obligations by vehicle assembly.

(6) This concentration on assembly in Canada was a result of the then existing conditions in the labour market. In south-central Ontario there was a chronic shortage of skilled workers and a more plentiful supply of less skilled workers who could be employed on assembly. While the agreement was being negotiated, many plants in Ontario producing farm machinery, construction equipment, or machine tools, were advertising for various categories of skilled workers. When the agreement imposed a substantial increase in production on the automotive sector it put great pressure on the market for the skills required to build new production lines or reorganize existing facilities. Wage rates rapidly reflected this fact, and no doubt part of the overheating of the manufacturing sector in southern Ontario in later years was a result of the requirement for a rapid increase in production in the automotive sector.

(7) The arrangements under which only the qualified vehicle producers could import vehicles duty-free was important in launching the restructuring required of those companies. Moreover, it was a technique that in practice gave a covert tariff preference to products of the United States. However, there was no assumption that this situation would last forever. On several occasions in the years since the agreement, consideration was given in Ottawa to a unilateral reduction by Canada of the most-favoured-nation tariff rate in order to force a reduction in prices and thus to reduce the difference between United States and Canadian prices for identical vehicles. The United States, moreover, pressed for duty-free entry to be extended to purchases by dealers and by consumers. This was opposed by the vehicle producers.

One of the effects of retaining the special concession for the vehicle companies has been that there has been a degree of insulation of Canada-United States trade in this sector from the influence of charges in exchange rates. That meant that a proportionally greater burden of adjustment to changes in exchange rates has been placed on other sectors of production and on other categories of transactions. This was particularly important during the period when the Canadian dollar appeared to be over-valued, primarily because of the impact on the exchange market of borrowing by Canadians in New York.

(8) As an obvious consequence of our entering into a preferential arrangement with the United States we have, in a practical and political sense, put ourselves under obligation to the United States with a con-

sequent loss of freedom to make policy choices. At the same time we have not succeeded in protecting ourselves in the long term against the effect of the 'institutional barriers' to trade. Clearly, the U.S. authorities may choose, as surely they have done from time to time, to press the companies to give greater weight to United States interests as perceived in Washington, and to give less weight to what Canada has wanted from them.

In the light of these considerations, it is not at all clear in just what way this outdated agreement should be recast. We let pass the opportunity presented by the Tokyo Round to negotiate some multilateral replacement to the bilateral agreement, which, to some of us, appeared to have served its purpose. My inclination would be to have a joint Canada-United States study of the North American industry, beginning with a new look at the evolving technology of vehicle and of parts production and in the light of changes in the structure of demand. I would not start such a study by assuming that developing countries have any comparative advantage in the automotive sector, although clearly some parts and some assembly can be done efficiently outside the industrialized nations. It would be critical that such a thorough study be carried out by individuals with a grasp of trade policies and also able to take into account the economies of automotive parts and vehicle production. It would be critical, too, that the United States not impose an adversary style in such a rethinking of what can be done by the North American industry and by North American governments to develop a new framework of trade relations rules for this particular sector.

I turn now to another major item on my short agenda of Canada-United States trade policy problems for the 1980s: that is the question of tax policy as it affects decisions on industrial location and as it affects trade. Of course we touched on this in the Tokyo Round. In the Subsidies/ Countervail Agreement we re-affirmed that a deferral of direct tax related to export performance was indeed a prohibited practice, but we accepted in a footnote that the United States is not going to scrap its export subsidy system (i.e. the DISC provision).

We noted, again in a note to the 'Illustrative List' of prohibited export subsidies, that exports to a related corporation should be on the basis of 'arm's length' pricing. The principle that the exemption of exports from a domestic commodity tax was indeed not a subsidy and not

countervailable was reiterated. But we addressed only these obvious trade policy aspects of tax policy that happen to have surfaced in GATT discussions. The major problems of 'border tax adjustment,' which the Trade Act of 1974 in Section 121(a)(5) had appeared to place on the Tokyo Round agenda, were in fact not considered. The intractable issue of the apparent advantage in trade relations terms, of countries that rely more on commodity taxes and rather less on income taxes than do other countries was not addressed.

For my part, I took this as evidence that in the United States the possibility was being kept open of the United States adopting some sort of general commodity tax, perhaps a value-added tax, from which exports would be exempted and which of course would be imposed on imports. This would be like a devaluation of the United States dollar for trade purposes. To Canadian exporters it would seem just like an across-the-board tariff increase by the United States, or like an import surcharge. Clearly, if this happened, there would be immediate implications for Canadian tax policy. Clearly, if any serious consideration were to be given to such proposals in the United States, there should be consultation with Canada.

Leaving aside the question of the structure and of the rate of taxation on corporate profits, and particularly the structure with regard to resource development, and the obvious requirement to concert tax policies in two economies so closely related, there is the whole range of tax measures that have a direct impact on decisions to invest in manufacturing or which directly affect export activities.

In my view, U.S. tax devices such as tax-free industrial revenue bonds, the investment tax credit, and domestic tax shelters for export income (the Western Hemisphere Corporation, and later the DISC) have produced effective subsidies for industrial development. I believe industrial case studies would show that these tax subsidies, sometimes working together in regard to a particular decision on plant location, have had perhaps a more important effect on trade than have tariffs and other overtly trade-related measures. It seems to me that this is a policy area where there will be more, not less, conflict in the years ahead. It is essential, therefore, that there be more effective consultation about such aspects of tax policy, and by officials who understand the trade policy dimensions of such tax measures.

Yet another item on the agenda of the eighties will be customs valuation. We have agreed to put in place, four years hence, a transaction price system. In broad terms such a system clearly has certain advantages, particularly for administration, over our present system. However, there are particular Canadian valuation problems that the code does not deal with adequately (end of-line goods, so-called 'seconds' and used capital equipment), and these will lead to difficulties with the United States. Of much greater importance is the proviso that our implementation of the agreement depends on our trading partners agreeing with specific increases in Canadian ad valorem tariff rates to reflect the change in the net effect of a given rate of the proposed change in valuation base. If, after holding its hearings, the Tariff Board reports that a large number of changes in rates will be necessary, we will be in for long and detailed negotiations. Such an exercise is bound to generate a good deal of suspicion and ill will in countries that export to Canada, not least the United States.

It is quite unfortunate that the United States in particular was not prepared to accept certain proposed provisions, consistent with Article VII of the GATT, that would have minimized the need for such rate changes. It might well be useful in these circumstances to consider the option of moving from our traditional f.o.b. to a c.i.f. basis. The effect of such a charge on the different regions of Canada would have to be examined, particularly should the United States also consider adopting the c.i.f. option.

It might be thought that with the great extent of duty-free of low-duty trade the question of valuation is of no great importance. However, it is critical to industries that still have significant tariff protection; moreover, there is the question of the valuation of imports for commodity tax purposes. The proposed change in valuation is an important reason for moving the base for our federal manufacturers' tax to the wholesale level.

These are examples of areas where there will be problems between Canada and the United States in trade policy relations in the 1980s. If you study these examples one common element will emerge: U.S. laws and policies that have been developed to deal with problems arising with other trading partners - others who are more powerful than Canada, but less important to the United States in the trade terms - often bear on Canada

more vigorously and rigorously than on those others. This is sometimes no more than the result of geography, of our being neighbours. Sometimes it is the fault of bad design. Rarely is it deliberate. Therefore I suggest that the first item on a sort of working agenda for the eighties in North American trade relations - an agenda for putting our affairs in order - should be a review in both Canada and the United States of legislation that bears on trade.

The purpose of such a review would be to ensure that the legislation of one does not affect the other North American partner more harshly, more vigorously - but unintentionally and unnecessarily - than it does others.

Of course there will be areas where one country has a policy to deal explicitly with a problem caused by the other. I am not arguing that we can make those problems go away, or that, given the volume of the trade and economic relationships between Canada and the United States, there will not continue to be bilateral issues of real difficulty. There are, for example, problems over a range of border issues, such as the trade in seasonal horticultural products, or the 'border broadcasting' issue, where the best we may be able to do is to work out truces that may stop short of the ideal. However, I am impressed with how much trouble is caused inadvertently, accidentally, by the failure to think out the North American consequences of trade policies devised to cope with problems generated overseas. Why not begin the search for a better trading arrangement here in North America by trying to get rid of some of these design faults? Clearly, this could mean more effort by the United States than by Canada. It is U.S. preoccupation with relations with Europe and Japan that is at the root of much of the trouble. Of course Canadians will have to be prepared to identify the trouble areas, and Canadians should certainly be prepared to review their legislation to the same end.

That is part one of the agenda. As we work through that agenda we could begin to judge whether there are product areas or policy areas where Canada and the United States do require special, more detailed, more radical solutions than are provided by the existing international arrangements or could be evolved multilaterally.

I have already made clear that, speaking personally, I believe we should work out a special procurement deal, perhaps modelled on, but not going quite so far as, the defence production sharing arrangement. I

suggest that for petrochemicals it will be hard to avoid an overtly preferential arrangement if we are to negotiate our way out of the present irrational position.

You will observe that I have not invoked the concept of free trade. By free trade, as I have noted earlier, is usually meant merely the removal of tariffs. I hope the fact is accepted that trade is now regulated and made not free by a range of other and more important policy devices. We can deal with these too, if we wish, in such a way that some sectors of North American trade are freer. In this fashion it might be that we would evolve, piece by piece, policy by policy, a special trading regime, or set of arrangements. These solutions would, of course, be a long way short of free trade, but they would be solutions to real problems that inhibit trade.

Let me give only one example of why the result will not be free trade but only freer trade. Neither Canada nor the United States is going to stop subsidizing industrial development in various and ingenious ways. Thus we are not going to free trade from this sort of intervention, which is, in a sense, an instrument of trade policy, just as are customs tariffs at the frontier. The United States is not going to give up the right to countervail subsidized exports from Canada; if Canada wanted that, then Canada would have to agree that the United States have a significant measure of control over Canadian federal and provincial industrial development subsidies. Clearly that would be very difficult to contemplate. But perhaps we could learn to consult about the parameters of major subsidy programs. We might, out of that process, devise a countervail regime that took into account the unavoidable asymmetry to which I have referred.

In summary: I would put procurement, subsidy policy and countervail, petrochemicals, automobiles, tax policy, and valuation at the early part of the working agenda, but it will be a long agenda. The United States will want to talk about oil and gas, about FIRA, about provincial rules regarding foreign investment, and about trade in services. Moreover, there will be a requirement for a new set of Canadian-U.S. institutional arrangements. Like Donald Macdonald, I think we might consider the International Joint Commission as a model.

I do have one more point to make: I have referred to trade relations between Canada and the United States, and I have used rather loosely the expression 'North America.' But there is a third North American economy.

For my part I would begin the eighties by including Mexico in the detailed discussion that my working agenda calls for. There are certain matters such as the trade in energy products and in petrochemicals, such as the trade in horticultural products (to take a quite different sort of product area) where sensible North American solutions to North American problems require the participation of all three North American governments. I wonder, too, whether some problems that Mexico faces in her relations with the United States are, like Canada's problems, the perverse result of Washington's preoccupation with other more powerful countries farther away. Let me put it this way: I would not add Mexico as an item on our agenda. Mexico is involved in virtually every item. In my view Mexico should be at the table, to agree to the program, to make its contribution, to gain from the working out of a somewhat more rational North American set of trade policies. Nor is it apparent that such an approach is in any way incompatible with Mexico's legitimate interests in regard to other countries in the Western Hemisphere or with entities elsewhere.

Carl E. Beigie

It is never easy to comment effectively on a paper by Rodney Grey on trade policy. His knowledge, shaped by years of experience in trade negotiations, is so overwhelming that it puts generalists like me in awe. If his paper had been sent to me as a journal article to be refereed - without the name of the author - I would have judged it by three criteria: content, common-sense judgement, and interesting policy proposals. My letter to the editor would have been brief: 'It scores very high on all three criteria. Publish as quickly as possible. And tell the author "well done."'

Grey starts his paper with three working assumptions that can be captured in a single sentence: the working out of a more formalized economic association with the United States, but short of free trade, should occupy one of the highest positions on the Canadian foreign policy agenda. The remainder of the paper is devoted to an informative enunciation of the main items he would place on the bilateral negotiating table at this time and a set of reflective comments on the results he would hope

to see from such negotiations.

The point of view reflected in the paper is one I have shared for several years but have been unable to express as effectively as Grey has done. It is also a view that has generated a good deal of interest among certain members of our Canadian-American Committee, including Donald Macdonald on the Canadian side and Bill Eberle, former Special Trade Representative in the U.S. government, on the American side.

Grey anticipates one of the most common criticisms of any proposal for a bilateral 'deal', namely that it is a plea for 'free trade', which, critics charge, is another step toward 'continentalism' and an eventual political union in which Canada would clearly emerge as the dominated partner. In denying that he advocates free trade, or even that he considers it relevant to the objectives he seeks, Grey will have soothed those potential critics somewhat. But his treatment of 'free trade' gives me one opening for a substantive comment on his paper.

Grey describes the case that is often made for free trade as being the outcome of a 'necessary teaching aid' - the theory of comparitive advantage as a source of gains from trade - as an academic exercise, reflecting sometimes an importing of 'the rhetoric of American argument ... and taking it in Canada ... for the genuine gospel,' and sometimes the 'accepting as revealed truth some purely self-serving attack by American (or EEC, or Japanese) exporters on what commercial policy we have.' Given the difficult negotiating tasks Rod has been assigned over the years, I can understand his point of view and his frustration at being urged to lower Canadian tariffs by countries that have been busily raising a variety of non-tariff barriers.

The concern I have, however, is that valid observations are often taken as support for invalid conclusions - in this case that free trade, approached through stages of freer trade, is only beneficial to Canada if this process leads at each stage to 'a balance of concessions,' to use a bit of GATT jargon, from all parties involved. The approach is natural for a negotiator seeking to show success for his efforts, but it usually overlooks, or at least underestimates, the advantages to the over-all performance of the domestic economy that might be gained from tariff concessions, even unilateral concessions, offered to foreign countries. It is my view that Canada's (and Ontario's) manufacturing industries still suffer from having grown up behind a set of protective policies and that the longer-

term advantages for Canada's competitiveness cannot be evaluated solely from a static balance sheet of concessions. In short, trade policy is a key element in Canada's search for a new national economic policy, and it is my hope that that search will bear in mind the proven advantages of free trade as real returns and not as a purely academic notion.

There is a set of premises in Grey's paper that describe effectively the situation facing Canada in the trade policy field:

- The recent Tokyo Round was unable to reach agreement on a number of important issues and has left many loose ends in some of the agreements that were made. The unfinished business is concentrated in areas concerning non-tariff distortions to trade.
- There is little indication that the major countries are anxious to begin another round of multilateral negotiations in the near future, and the tying together of loose ends arising out of Tokyo Round agreements will be done in a legalistic context at a time when tempers are likely to wear thin rather quickly if, as I suspect will be the case, unemployment rivals inflation as a policy problem around the world over the next several years.
- Canada has a major interest in the unfinished business and loose-ends of international trade policies and could get caught in a squeeze play over the next several years in two senses. First, tariff reductions will continue over the next eight years, exposing Canada to greater import competition. These tariff cuts will open foreign markets to Canadian exports, but the full advantages for Canada will be curtailed if agreement on implementation of codes of conduct in the non-tariff distortion area is seriously delayed. Secondly, Canada may find the United States so preoccupied by irritants to its trade with Japan and the EEC that Canada will see too little progress made in areas having a particular importance in the bilateral Canada-U.S. context. (Grey notes, for example, that as a result of developments in the Tokyo round, countervail is now a 'potentially . . . more punitive device than it was before.')
- In the absence of multilateral progress, 'bilateral solutions to trade policy problems could yield substantial results.' Rod cites the Canada-United States Automotive Products Agreement as a case in point. Different views have been expressed as to the success of that agreement, but few who know its background fail to recognize the co-operative spirit in which it was made.

- Grey's proposal for a 'GATT within GATT,' is in effect, an idea that has been around for some time, although other suggestions have contemplated that more participants would be involved. Indeed, many commentators have argued that this may be the only way to sustain any real momentum toward further liberalization of trade. This proposal raises three key interrelated questions in the bilateral context:

1 Is Canada going to be able to move beyond political rhetoric and think through clearly what it hopes to achieve from a new national economic strategy? As I have already noted, trade policy will be, in my view, a crucial element in such a strategy.

2 What will it take to persuade the United States to join a bilateral negotiation of the sort Grey has in mind? Will Canada be prepared to put into negotiation a wide enough range of issues to make the exercise worthwhile for the United States?

3 What new institutional mechanisms will be put in place to implement whatever agreements can be reached in bilateral negotiations?

To conclude my comments, I would like to focus briefly on the second of these questions - enticing the United States into negotiation. If I may be permitted to wax philosophical for a few minutes, the basic characteristic of the world economic scene over the last several years of the 1970s is policy impasse. I would attribute this largely to the belief that policy initiatives produce predominantly zero-sum, or even negative-sum, outcomes. A major cause of this perception has been a significant improvement in the public relations abilities of interest groups representing persons who might be affected adversely, even if only temporarily, by various policy initiatives. Simultaneously, the principle exponents, traditionally, of the positive-sum dimensions of policy initiatives - economists - have witnessed a serious deterioration in their influence and credibility. Contrary to the position that many economists have allowed themselves to slip into, namely that their value to society is a function of the accuracy of their forecasts, the main skill that economists should possess is in the domain of general equilibrium analysis - meaning an awareness of the full dimensions, across sectors, groups, and periods of time, of a policy action that is taken, or one that is not taken. A capacity to comprehend such general equilibrium consequences is essential to effective policy formation.

My sense is that the Canada-U.S. relationship has gradually come to be seen on both sides of the border as at best a zero-sum proposition, as opposed to the positive-sum dimensions that used to dominate perceptions in the early post-war period. The turning point, I think, came in the aftermath of the auto pact. If you accept this analysis, several conclusions emerge that I think are relevant to the question of getting the United States to the bilateral negotiating table.

- The agenda for negotiation cannot be excessively restricted at the outset. If Canada announces that, say, this country's energy and foreign investment policies are not subject to inclusion on the bilateral agenda, then the negotiations are unlikely to begin.
- Canada must take a broad and more informed view of what would represent success for this country from such a negotiation. I have found over the years that economic analysis of the advantages Canada might gain from the bilateral relationship is presented logically, while the analysis of the costs of what it might have to give up to attain those advantages is more emotionally appealing.
- Bilateral negotiations cannot be expected to resolve the internal economic problems of either country. This point is particularly important for Canada. If one of the criteria of success in bilateral negotiations is to produce a much more balanced distribution of manufacturing activity across Canadian regions, forget it. If bilateral negotiations should be expected to improve anything, it is the efficiency in Canada and United States of resource utilization. It is up to Canada to decide how the benefits of such improved efficiency are to be distributed so as to achieve a state of reasonable harmony in this country. A more formal economic association with the United States will, of necessity, constrain the range of instruments for pursuing that goal.

Two final points, one that is covered briefly in Grey's paper and one that is not. First, Grey suggests that Mexico be included in the negotiations he calls for. This suggestion makes sense for the United States, given its preoccupation with obtaining increased energy supplies. I am not at all certain, however, that that would be in Canada's interest. Mexico is so filled with Third World emotion and rhetoric at the moment that the negotiations would probably be far more acrimonious if the

Mexicans were included. My suggestion would be that the negotiations be at a bilateral level but with the understanding from the outset that other countries could subsequently become 'contracting parties'.

Secondly, over the years I have been impressed with the shortage of policy-formation skills, in relation to the magnitude of policy-formation tasks, in Canada. The only way to bring about equilibrium between supply and demand has been to create a highly elastic supply of 'back burners.' If trade policy is to receive a high priority among competing demands, it must be pressed by forceful advocates. My reading is that the long-term interests of the Province of Ontario dictate that it must play the lead in mobilizing this effort.

Discussion

T.E. KIERANS: I recently had the opportunity to discuss the Chrysler situation with some of our own officials and therefore had the occasion ot re-read a lot of the documentation. It struck me at the time how quickly we become immersed in our own mythology. When one re-reads the auto pact one remembers the emphasis at the time we put on assembly and not on parts, and suddenly we act as if the parts deficit was something due to us, and that is the subject of very great concern.

In reference to the point that Carl Beigie has just made, we really wonder if we have the will, in terms of bilateral trade negotiations, to put our resources into the package, not just in the sense of a three-year contract, but in the sense of a contract in return for the quid pro quo it will really deliver over an extended period of time.

However, I am obliged to say that I do wish that economists would also look more often at the institutional barriers that affect us, be they sociological or whatever.

Macroeconomic trends and international trade: a general overview

T. A. Wilson

The main theme of this conference is stated clearly by the title: Developments Abroad and the Domestic Economy. However, the papers prepared for the conference also emphasize a major subsidiary theme, namely the adjustments to the external shocks that our economy faces, and the appraisal of policies, present and future, that might help us adjust to or take advantage of those shocks.

My first task is to provide relevant background information on the Canadian economy and on developments in the rest of the world. Because of the importance of the United States economy I think that in this context 'world' should have the same meaning that it has in baseball. As far as Canada is concerned, we can focus principally on the United States and Canada in examining the issues posed by the macroeconomic trends. My second task is to introduce some of the policy issues that are dealt with in the other papers.

Let us then begin by considering what the important basic economic trends will be in the 1980s. The reason I pick the 1980s is of course that the implementation of the Tokyo Round of tariff reductions will take six years, and, if past experience is any guide, the next round of multilateral negotiation will not be completed until a few years later.

The other speakers have avoided prognostication, so I felt that I should assume the uneviable role of crystal-ball-gazer, the phrase used in one of the papers. I am going to draw upon projections from two econometric models, and those of you who have used these models know that they are very much like crystal balls, in that econometric forecasts are also fragile. However, to quote Winston Churchill, 'I have not always been wrong about the future course of events'[1] - even in long term pro-

1 Winston Churchill, speech delivered at the Guild Hall on receiving freedom of the City of London, 30 June 1943

jections. Some time ago Harvey Lithwick[2] and I did a study of long-term growth for the Royal Commission on Taxation, in which we projected a higher growth of potential GNP than previous authors. However, we had a logical basis for doing so, in that capital formation was much stronger after 1945 than between the wars and during World War II. Our study underestimated the growth of potential GNP; that doesn't bother me much; I am pleased that we detected the acceleration in the rate of growth.

Looking ahead into the 1980s it is harder to be innovative, becaue a very broad consensus has emerged among those who look at the 1980s as to what the developments will be on the supply side. Indeed, in some respects it is easier to do long-term projections than short-term forecasts, in the sense that long-term developments really rest fundamentally on aggregate supply conditions. When I refer to long-term developments I am not concerned about the precise value of GNP in 1990, or any other particular year, but what trends are likely to occur during the decade. The first and most important trend apparent in our economy and in the American economy and, insofar as data is available, the economies of the big four in Europe and Japan as well, is a marked slowing of potential growth. The estimates of potential growth for Canada over the next decade range from 3.1 to 3.9 per cent. Now that is probably much narrower than is reasonable, given our lack of information about the 1980s. But it is noteworthy that all estimates call for a marked lowering of the growth of potential output compared to the estimates of 4.8 or 5 per cent over the ten or fifteen years.

One of the two projections I have worked with is a CANDIDE model projection[3], which showed potential growth to the mid-1980s to be 3.1 per cent. The other projection is the latest Data Resources (DRI) trend forecast[4] which projects potential growth over the decade at 3½ per cent, with not much difference between the two halves of the decade. Both of those estimates are significantly lower than estimates of potential growth over the past ten or fifteen years. The sources of the slowdown of the growth of potential output are readily identified. First are the demographic changes.

2 T.A. Wilson and N.H. Lithwick, The Sources of Economic Growth. Study No. 24, Royal Commission on Taxation (Ottawa: Queen's Printer, 1968)

3 D.P. Dungan and T.A. Wilson, Potential GNP: Performance and Prospects. (Ottawa: Economic Council of Canada, forthcoming)

4 This projection is reported in the Spring 1980 issue of Canadian Review 4, No. 5 (Toronto: Data Resources of Canada)

The passing of the baby boom generation into the labour force, and changes in immigration policy in this country will lead to a marked slowdown of labour force growth in Canada. That is the most important factor contributing to the slowed growth of potential.

The second source is that capital formation will likely shift into capital-intensive sectors, with lower real output-capital ratios. This shift is due mainly to the reaction of investment decisions to major changes in relative energy prices and to related policies, with a consequent shift of capital investment towards the energy sector, which tends to be a capital-intensive sector.

Much more disturbing than these developments, which can be quantified in the normal way, is the possibility that total factor productivity growth - the amount of output we get out of any given amount of capital and labour inputs - will also be slower. Indeed, in the United States recently total factor productivity actually declined over a three-year interval. This development has been analysed by Dennison,[5] but remains largely unexplained. In looking at total factor productivity growth in the context of the disaggregated CANDIDE model, Peter Dungan and I found that total factor productivity growth had declined dramatically in recent years. We estimate that, from 1961 to 1978, potential productivity growth in Canada was a healthy 1½ per cent a year, but from 1973 to 1978 it dropped to 0.5 per cent.[6] So there is a question whether total factor productivity growth will be as high in the future as in the past or whether it will continue at its recent low rates of increase. The projections I refer to include some recovery from the recent low rates, but not back to the earlier averages. In the CANDIDE projections, total factor productivity growth over the next five years is projected at 0.7 per cent. In the Data Resources trend projections, total factor productivity growth averages 0.8 per cent over the decade.

According to the evidence the prospective growth trends of our major trading partners are also lower. The latest Data Resources estimates for the United States over the next decade are for potential growth of 2½ per cent, which is down from 3¼ per cent in the past decade and from about 3

5 E.F. Denison, 'Explanation of declining productivity growth,' Survey of Current Business 59, No. 8, Part II

6 Since these estimates are based, for the most recent period, in part on preliminary data, they are subject to revision.

3/4 per cent in the sixties.[7] The estimates would probably be similar for Canada's major overseas trading partners, although the levels are dramatically different. In Japan we should be looking for declines from historical trends of 10 per cent in the sixties to perhaps 6 per cent in the eighties.[8] In Europe the prospective slowdown is quite dramatic, with projected growth over the decade declining almost to the U.S. level.[9]

We can reasonably expect, given the slowdown in the growth of aggregate supply, and given very cautious macroeconomic policies, that the growth of realized output is also going to be slower. Certainly realized growth is unlikely to be near the rates attained in the 1960s (the 1970s were a peculiar decade, dominated by the adverse cyclical developments since 1973). This means that in the typical market for Canadian output only moderate growth may be expected. Boom growth conditions are unlikely to occur over any sustained period of time in the eighties. If there is a boom it will probably be shortlived, because there will probably be restrictive policies in reaction to the boom.

Let me turn to another important macroeconomic condition of the decade ahead: persistent price inflation. Indeed, the persistence of inflation is the reason for the cautious macroeconomic policies that serve to limit realized growth. The projected inflation rate is related to expectations of inflation, relative energy price increases, and price inflation abroad. Entrenched price expectations, which result mainly from the fact that we have now had a decade with an average inflation rate above 8 per cent and from the fact that current inflation rates are near double-digit levels again, are the principal domestic source of the projected rate of inflation. The need to absorb significant increases in relative energy prices is the second domestic source.

World oil prices are likely to rise in real terms at least moderately over the decade; the DRI projections assume a 3 per cent increase in real world oil prices. In Canada we have to face additional increases owing to the adjustment of domestic oil prices towards world levels. A blended

7 These estimates are reported in the Spring 1980 issue of U.S. Long Term Review (Lexington Mass: Data Resources Inc.)

8 For projection of the Japanese economy to 1987, see the January 1980 issue of DRI/NIKKEI Japanese Economic Review 7, No. 1. (Lexington, Mass.: Data Resources Inc.)

9 For long term projection of the major European economies, see the June 1980 issue of European Review 7, No. 3 (Lexington, Mass.: Data Resources Inc.)

pricing formula that adjusted prices towards a weighted average of world prices and current real domestic prices would result in an annual average increase of 19 per cent over the next ten years.[10] Canadian energy prices need to be adjusted, and whether you choose the previous government's target price of 85 per cent of the U.S. price, or whether you choose the new government's blended price (as yet unstated), we are still going to see large increases in the decade ahead. The blended price formula mentioned above would yield a price in 1990 of $91 Canadian a barrel for oil, which would be roughly 80 per cent of the projected U.S. price at that time. That is one blended formula: others would of course yield different results. However, under any sensible blended formula, the domestic price will eventually approach the world price because in the very long run all existing conventional oil will be extracted and if all the new oil is valued at its opportunity cost, which is the landed price of imports, the formula would gradually phase in the world price. In any case, whether we move to 75 per cent of world price or 85 per cent, we can expect large increases in domestic energy prices during this decade.

The final source of the projected inflation rate is the inflation rate of our trading partners. This remains important even with a flexible exchange rate because we are inadequately insulated from price developments abroad. The price inflation that occurs in the United States during the decade is particularly relevant: it is projected to proceed at 8½ per cent.[11]

As a result of these factors, price inflation in Canada will moderate at a painfully slow rate. In the first five years of the 1980s the consumer price index is projected to increase at an annual average rate of 8.6 per cent. In the second five years, the rate of inflation diminishes to just 7.8 per cent. Of course it can be reduced more significantly if we are prepared to run a severe recession for long enough. The problem really results from the structure of the wage-price system. It is very difficult to reduce inflation rapidly through higher unemployment. In fact, it would require unemployment for several years at levels that we would not at present regard as acceptable even for one year, to bring the inflation rate down significantly by that means.

10 In this formula, existing conventional oil is projected to rise in line with the general rate of price inflation, and new oil and non-converted oil prices are adjusted rapidly to world levels.

11 See note 7 above.

Now this doesn't mean that I think macroeconomic policy will, or should, abandon the fight against inflation; rather it means that we have to recognize that this is a very difficult goal to achieve, and it is going to take a long time to reduce inflation significantly unless we are very lucky, and I do not think there is any reason to assume that we will have good luck. The most likely macroeconomic policy position will be to aim at bringing inflation down gradually over the decade.

The high and rising energy prices that I have already commented on are also serious problems in themselves, as well as being factors that exacerbate the general problem of inflation. These relative price increases create problems of adjustment from a microeconomic standpoint. Indeed reading the papers by Flatters and Purvis for this conference took me back to the energy conference of last fall,[12] which focused on this issue.

The rise in energy prices that has already occurred and the prospective increases ahead of us, have not only caused much of the shift in investment towards the energy sector, but they will also necessitate major resource allocation adjustments by producers and consumers in the future; these are discussed in both the Helliwell and Flatters and the Purvis papes. One can argue that if we delay this adjustment too long we will see an entrenching of inefficient production processes and also of inefficient consumer capital as well.

Another important aspect of energy prices is that they imply very large current account surpluses in the OPEC countries and this necessitates very large, continued financial recycling of these surpluses. A recent essay by Brinner and Yunn[13] projected an OPEC surplus of $132 billion in 1980, and $145 billion in 1981. That is not just large in absolute terms; it is a tripling of the surplus in four years. A very significant increase in financial recycling is involved, even after taking into account likely increases in OPEC imports of industrial projects.

Those are the three important general economic trends that any country in the Western world has to be concerned with. What do they imply for macroeconomic policies, and for trade policies? First we have the

12 Energy Policies for the 1980s: An Economic Analysis (Ontario Economic Council: Toronto, 1980)

13 R. Brinner and Y. Yunn, 'Prospects for OPEC trade with the industrial world: will the OPEC appetite for goods equal its appetite for dollars?' World Economic Bulletin 1, 101-25 (Lexington, Mass.: Data Resources Inc.)

obvious problem of inflation, which is now very generally recognized by governments, the general public, the business community, and the academic community. Given this concern about inflation, policy makers will likely aim at the maintenance of what I would call a safety margin of excess supply in the economic system. There will not be macroeconomic 'fine-tuning', although political realities will obviously dictate some fiscal response to any serious recessions that occur. However, it will be a rare year in the 1980s when we see the unemployment rate at or below its equilibrium level. Fortunately, the equilibrium rate of unemployment is likely to decline during the decade, owing to the recent tightening of the unemployment insurance system and to demographic developments, in particular, the aging of the young men and women who are at present contributing to a high equilibrium unemployment rate. However, the presence of persistent involuntary unemployment will exacerbate regional problems and difficulties in specific industries during the decade, and I think that may have serious implications for policy developments at the micro level which could affect international trade.

Let us briefly consider the implications of these developments for financial markets and flows of funds. Financial markets may be characterized as learning to live with both inflation and monetarism. We are going to see monetarist policies helping to maintain the margin of excess supply, but they will at the same time clash with the persistent rate of inflation. Long-term interest rates may decline gradually as inflation declines, but it is not likely that we will see a dramatic sustained reduction because there is not likely to be such a reduction in inflation.

The persistence of inflation will magnify apparent debt-recycling problems and distort the interpretation of savings flows. We can expect throughout the decade that personal savings rates, the balance of payments deficit, and the Government deficit will all look high, but this will simply reflect the inflation component of interest paid[14] on debt owned or owed.

More important than this, because one hopes that people will learn eventually to interpret such numbers correctly, it that there will be con-

14 For an analysis of the impact of inflation on savings flows, the balance of payments, and government deficits, see G.V. Jump, 'Interest rates, inflation expectations, and spurious elements in measured real income and saving.' Discussion Paper No. 150 (Ottawa: Economic Council of Canada, forthcoming)

tinuing distortions of tax burdens introduced by this persistent inflation. Let us hope that the need to complete rather than to abandon the indexing of the tax system, will become compelling, even to a Minister of Finance, before the decade is over.

Let me comment on some other general issues before turning to trade and foreign economic policies. First, are there any discernible trends in the composition of aggregate demand that may be relevant when we assess the prospects for trade? Some recently established trends will probably continue. The shift to activity from the public to the private sector, which has become apparent in the last few years, should continue, and is related to two fundamental developments. The first is the need to maintain a conservative fiscal policy, which is part of the general policy of maintaining the margin of excess supply I referred to earlier. Secondly, and probably more important, demographic developments during the eighties will significantly reduce the demand for public services. My colleague David Foot[15] has analysed the demographic influence on the demand for public services and finds that the 1980s present a brief interlude in which we can really bring public spending growth under control.

A second important trend that should continue is a shift towards investment activity, in large part related to investment in the energy sector, but also related to the improved international competitive position of our manufacturing sector.

Looking at consumption, which is also likely to rise in relation to the aggregate output, I expect we will see a shift towards the type of spending that would appeal to young adults and childless couples, i.e. on items such as durable goods and other services, and away from housing and necessities.

The total volume of trade will probably expand in line with the growth of real GNP, which will be roughly 4 per cent over the decade (this is slightly higher than the potential growth and reflects some improvement from the current dismal levels of capacity utilization). However, the value of trade will probably rise faster than the value of nominal GNP, because the price of energy and raw materials will generally be rising faster than prices in general. For Canada this implies some im-

15 D.K. Foot, 'The economic impact of aging in Canada - some macroeconomic indicators.' Paper presented to the Eastern Economic Association Meetings, Montreal, 8 May 1980

provement in the terms of trade over the decade.

Getting away from macroeconomic policies, and considering more detailed policies - I find I am now gazing into a much cloudier crystal ball. If we look at changes in the tax structure and this is perhaps more a hope than a forecast, I imagine any changes will be designed to reinforce the shift towards investment. In other words, there will possibly be steps taken to reduce the tax burden on investment. Other possible policy developments I am not so sanguine about. I agree with Douglas Hartle whose paper predicts that we will see increased reliance on policies that do not explicitly enter the budget accounts, where there are no dollars and cents figures on either side of the budget with which they can be appraised. I refer of course to regulatory and related policies.

Let us now briefly consider the implications of these broad developments for trade and for foreign economic policies. The United States, despite its slow growth, will remain Canada's largest trading partner. The more rapid expansion of Japan will present opportunities for increases in the share of our exports that go to Japan. However, in Europe very slow growth is projected over the next decade, paralleling the U.S. situation. Taking into account likely changes in the composition of U.S. demands, the particular opportunities for improvement of trade would appear to be concentrated in capital markets, in services, in industrial materials excluding fuels, and in consumer goods excluding automobiles.

The over-all energy balance, which is in a small surplus at the moment, will probably move to a deficit of about $2 billion by the middle of the decade and then recover to a surplus of about $2.7 billion in 1990. Again this reinforces the view that the energy situation is important to Canada mainly for the way we handle our domestic prices and for the impact of energy developments on our trading partners, rather than for massive changes in our balance of trade in energy.

The implications of these broad trends are that any effect that trade liberalization under the Tokyo Round, which is detailed in John Whalley's paper, may have on total trade or total exports for Canada could easily be offset, and indeed I suspect probably will be, by the effects of slower world economic growth in the decade ahead.

The Canadian economy is also likely to remain highly vulnerable to cyclical shocks from the U.S. economy. As noted earlier, Helliwell in his paper considers the extent to which we could insulate ourselves from such

shocks, and finds this insulation to be incomplete. If we compare the growth pattern in Canada that would obtain during the 1980s with relatively stable growth in the U.S. and that which would obtain with relatively cyclical growth in the U.S., we observe dramatically different patterns. With trend growth in the United States, we could have fairly steady growth in Canada over the decade, ranging between 3½ and 5.2 per cent a year, which is a very narrow range in relation to recent experience. Under conditions of cyclical growth in the United States we observe a range of growth in Canada from virtually zero to about 7 per cent, a much more variable pattern. If we consider export growth, the amplification of the cycle is even more apparent: with the U.S. economy experiencing trend-like growth, the growth of Canada's exports varies from 1.2 to 3.1 per cent, but with cyclical growth in the U.S. the range is between a decline of 3.4 per cent and an increase of 9.4 per cent. Furthermore, under cyclical growth conditions it is going to be more difficult to attain any reduction in price inflation. We unfortunately are dealing with situations where strong demand shocks can have a positive effect on prices, and also with supply shocks that are likely to have positive price effects. As a result, the inflation rate in the trend-growth situation does come down - painfully slowly - to a decade average of 8.2 per cent; whereas under cyclical growth, inflation averages 9.1 per cent, even though the average unemployment rate is somewhat higher under cyclical growth conditions.

We therefore remain very vulnerable to cyclical developments in the United States and cyclical shocks will exacerbate the inflation-unemployment trade-off we face.

What are the implications of these developments for possible changes in trade policy, and what might the side effects be on other policies? The maintenance of a safety margin of excess aggregate supply, which I think would be desirable on macroeconomic grounds, unfortunately implies increased political and economic demand for measures to bail out or protect the losers in any re-allocation of resources. Moreover, since aggregate growth will be more moderate, we will not likely experience the boom conditions that enable people from a declining industry to find jobs elsewhere, so we will have increasing public pressure for relief for specific industries or regions. In other words the likely macroeconomic conditions may lead to increasing political pressure for some form of protection.

Effective non-tariff barriers to trade may be erected by the many means available to government, as is lucidly discussed in Rodney Grey's background paper for this conference. Because of concern about the size of the federal budget we can expect budgetary measures to be replaced by non-budgetary measures such as regulations, with the result that many protectionist policies that are adopted will be difficult to detect and appraise.

I think we can indeed expect continued demands for increased protectionism in this country, but perhaps under some other name, indeed perhaps in the guise of an industrial strategy. Douglas Hartle's paper has some very interesting recommendations for changing the decision-making structure to reduce the bias in favour of special interest groups over the general interest groups. I think I would concur with most of those recommendations. I would also add more narrow economic policy recommendations. I think there are a number of general policies that would both facilitate the adjustment to new opportunities and ease the burden on persons who have to adjust to reduced opportunities as a result of international or domestic economic shocks. The first would be a review of research and development policies, in order to determine an efficient general incentive system. I would emphasize 'general', because although there is a strong case for public policies to encourage research and innovation, such policies need not have a specific industry focus. The second would be development of a very general and very generous income support system to reduce the adjustment burden on individuals. The third would be a comprehensive reform of the tax structure to eliminate its present bias against investment and risk-taking by the extension of indexing to cover capital cost allowances and capital gains, and by the provision of more generous allowances for deduction of losses.

Finally I would like to see - as a transitional measure - some portion of the great windfall of Federal-Provincial revenues that is going to accrue from adjustment of energy prices to world levels ear-marked as subsidies for energy-saving investments and other necessary adjustments to higher energy prices by firms and individuals.

After reading Doug Hartle's paper, one feels that such recommendations have little chance of being adopted compared to measures that favour special interest groups.

I should like very briefly to discuss international investment. I think

we can expect foreign direct investment and the role of multi-national firms (whether or not their headquarters are in Canada) to continue to expand. If we consider the basic causes of this type of investment I think we can see reasons for further growth.[16] Because we are going to be catering to people with higher income and more leisure time, at least collectively, we can expect to see more product differentiation in consumer markets. This is one area in which multi-nationals tend to thrive, because they can exploit intangible capital in other countries. I think we can also expect to see increasing technological complexity of producer goods, another area where there is considerable intangible capital, not always covered by patents or exploitable through explicit contractual arrangements, which can be exploited by multi-national corporations. Finally, because of the success of OPEC and the threat (although less serious) of other raw materials cartels, the desire to establish a secure supply of raw materials will probably encourage vertical direct investments by multi-natonal firms.

For these reasons we may expect to see continued foreign direct investment in Canada. We may also expect continued public concern about foreign direct investment in Canada as a result. Support for restrictions on such investment will be found in the same circles that support a protectionist industrial strategy. These issues are considered at greater length in the Wonnacotts' paper.

I should perhaps note in passing that in aggregate terms, Canada is likely to remain a net capital importer over the decade, but the net volume of borrowing abroad will probably be considerably smaller in relation to GNP at the end of the decade - about 1 per cent compared to two per cent at present.

Let me close by raising an issue that many find increasingly disturbing: the increase in the recycling of petro-dollars as OPEC surpluses rise to record heights. I mentioned earlier that one projection shows these surpluses tripling over the four-year period from 1977 to 1981, reaching a level of $145 billion dollars. Particularly disturbing is the role of financial intermediary being assumed by Western financial institutions in covering the deficits of the developing countries that do not themselves have oil. I raise the question whether we have either the international institutions or

16 For a discussion of the factors influencing foreign direct investment, see R.E. Caves, 'International corporations: the industrial economics of foreign investment.' Economica 38, 1-27.

the political leadership to cope with a major default in the chain of international lending that is being established by this very complex financial recycling.

John Grant

I very rarely find myself in any disagreement with Tom Wilson, and I was pleased to note that I could find a few structural flaws in his own crystal ball, one of them good for us and one of them, I think, bad for us. I think there is a consistent world strategy, and if I had to describe it quickly I would say that there are two components: one is monetarist gradualism, which, around the world, has come to be the dominant approach to fighting inflation, and the second element is the decision by the United States to cut oil consumption as fast as it can, almost at any cost to the internal arrangements of the economy. Now where I part company with Wilson is in the belief that gradualism is finally going to show some results. I think Tom was close to repealing the quantity theory of money with his theory of 'entrenched inflation.' What is entrenched are inflationary <u>expectations</u>. But expectations have a disturbing habit of proving inadequate to the facts. I think the classic signs are all there for a sharp slump in commodity prices. In fact the very forces that Tom rightly points to in the unfinanceability of some developing countries - commodity exporters - suggests that this is going to be the force that brings down many prices much faster than most people are bargaining for. In any case I think that very, very concentrated monetarist forces have been at work for many years without showing very visible results, but that the results will come with disturbing suddenness for most observers who still do not believe them.

I think the decision in 1978 to adopt a monetarist, gradual slow-down strategy to meet the OPEC challenge has on the whole been reasonably successful. We have had to face a lot more OPEC inflation than we foresaw, and the Soviet thrust has been faster and more decisive than had been expected, but as world leaders now convene to set new strategy for the next few years, my guess is that the new strategy will be to continue with the old one.

Europeans decided in 1978 that they would speed up their economies to counter-balance the expected 1979 slow-down in the United States. This strategy would with one stroke lessen the balance of payments imbalances and reduce the embarrassing high over-appreciation of the German mark against the U.S. dollar. Well, those things have actually happened. Exchange markets have been surprisingly and pleasingly stable, the balance of payments movements of all of the developed countries have been in exactly the directions predicted, the Europeans and Japanese are all running now in the direction of higher trade deficits, and the American trade account, aside from oil, is looking very, very strong indeed; so with the exception of the unplanned further OPEC provocation, the policy has in general been working. I think the Americans will stay with monetarism. I think the fact that Carter is facing Reagan rather than Teddy Kennedy as his major challenger implies a great deal about the public acceptance of that kind of policy. But, these reasonably optimistic things said, my disagreement with Wilson is that he was not clear enough about how bad our remaining problems are going to be.

I think the biggest single question is the one he identified: how to deal with the problems of the developing countries, the non-oil-exporting countries that are going to be the goats in this synchronous slow-down that is coming.

Before I talk about the developing countries and the recycling problem, I should like to discuss protectionism. So far, I think one can say that the problems that are arising are simply the traditional 'squeaking wheels.' There are, after all, major shifts of relative costs going on in the world; many fiscal and commercial policies that we have inherited were old compromises that worked when relative prices and costs and industrial structures were based on cheap oil. They do not work any longer. Look, for instance, at the European Economic Community's great difficulties in setting a budget that will be fair to all the partners. The UK is contributing far more than it is getting back, which is largely a result of a sharp shift in relative costs and advantages across the EEC.

The Japanese happen to be particularly adroit at making small cars. They are aggravating the Americans' and the Europeans' massive adjustment problems. We can expect to see efforts to protect those industries, certainly in the short run. Canada's fiscal equalization structure is another obvious casualty of the relative cost shift between oil, natural gas,

and other commodities. We are going to see incredible surpluses in the west; the federal government is the goat on that one. Canada's whole fiscal structure needs to be totally reformed. The 'lamb war', and the textile war between the United States and the EEC (again based on relatively cheap energy underlying textile exports from the United States to the EEC) are not generally protectionist policies rising out of a general malaise in the world economy, such as we saw in the early thirties, but rather symptoms of the struggle to evolve the new policy arrangements and compromises required by a massive shift in the way the world works. I do not see them as basically inimical to the hopes of the Multilateral Trade Negotiations.

Unfortunately, we have not seen the tough days yet. We are really just sliding into the slow-down. Next year, and the year after that, we will have to deal with the continuing effects of the contractionist policies that are now being followed universally. In Canada, there continues to be inappropriate concern in many quarters about the high federal deficit. But if you add together the high federal deficit and the growing western provincial surpluses, Canada's fiscal policy is moving very rapidly in a contractionary direction! Assuming there is no change in monetary policy, we may over-contract fiscally here because of our revulsion to inflation. If such policies are copied elsewhere, one should ask whether the response to that in turn might be inappropriate, i.e. generally protectionist in the good old thirties tradition.

Wilson spoke of the challenge that the recycling game is going to pose to international financial institutions. No one is more aware of it than the institutions themselves. You can hardly buy a copy of the Financial Times of London these days without seeing a speech by Walter Wriston (of Citibank) or someone similar complaining of the burdens of increasing 'country risk.' I have seen different estimates of the OPEC surplus than Wilson; one is that this year the surplus will be about $115 billion U.S., of which the industrialized countries will bear about forty-eight billion and the developing, non-industrialized countries about sixty-eight billion. Now that is not too great a problem for 1980, because many of those countries have had excellent terms of trade or excellent export volume, or both, in the European, U.S., Canadian, and Japanese markets. Also, some have pre-borrowed their needs for this year's financing to a degree. As a result, we have not actually had many paroxysms so far. For 1981, I

have seen a guess that the OPEC surplus might fall to the ninety-five billion range, but unfortunately that forecast suggests that the developed countries will get all the benefit. In the context of a general slowdown, OECD deficits may drop to twenty billion, but the commodity exporters' deficit will rise. That really will begin to cause a massive heartburn, because those countries have very few sources of strength to turn to. In their desperation to stay financed, they may start selling their commodities at lower and lower prices, so their terms of trade will deteriorate. That in turn will turn into the standard vicious circle of financeability. Already many major U.S. banks that are in international lending are making more than fifty per cent of their loans to international borrowers. They have had enough; they do not want to take on additional country risk. One can easily imagine, as the situation deteriorates, the 'statesmanship' involved in staying with it. It is going to be harder and harder, as their staff credit analysts keep telling them that the situation in terms of straight credit risk is deteriorating, rather than improving.

Top-rated international borrowers are still paying very, very low spreads in the international borrowing markets. There is no question that the funds are available. Euro markets will be swimming in funds; indeed they are already because the surpluses have to be recycled. But it is only natural to think that the investment preferences of lenders will gravitate towards U.S. Treasury bonds and the like. The problems of the Zaires of the world are going to receive less and less willing attention unless steps are taken at a high level. Can we hope for those steps? OPEC has begun to put a great deal more money into Arab development banks directed specifically at the developing countries. There is a good deal of bilateralism now developing in country-lending situations. OPEC has lent directly, for instance, to Germany - that was an easy one - but I think we will find individual safety nets designed from one case to another. I think that institutions like the Export Development Corporation, here in Canada, have an important role to play in the indirect recycling. Canada is a good, stable, and well-financed borrower. We may be able to borrow on the one hand and then through our own agencies such as EDC, lend to our favourite suppliers. Through a multitude of such channels one can imagine the problem being constructively handled. However, as in the Chrysler case, it may just go too far too quickly. The available reserves of financial statesmanship may not be able to catch the key one before it

cracks and begins to erode the structure of confidence on which the whole thing depends. Ultimately the only backstops are domestic central banks standing behind their own domestic commercial lending banks. I do not think that is really enough, so I have greater worries than Wilson. I think if we are going to be pessimistic to-night, we should let that be one of the areas to worry about.

Now let me just finish quickly. I think that Ontario's main problem (or one of the main ones) is to face the domestic consequences of the international adjustment. We are, of course, in the North American car and parts business, and we wish we were not. We are getting caught by Canada's fiscal structure, which is no longer adequate; the system of provincial fiscal equalization is dead against us at the moment and that is going to be a tough situation to get ourselves out of. We will be badly hurt, as Wilson mentioned, by the slow growth of the eighties. Many of the industries that we built our strength on will decline. Take construction for instance, which has been important for Ontario. In a world that is growing more slowly the construction industry must take a lower profile, and there will be serious problems of transition. I have one solution that I would suggest for public policy, and that is to facilitate changes in the labour market. We have to help workers decide for themselves where the opportunities are best, and ease their problem of deciding before their present jobs disappear and when the new jobs appear to them to be available. We need not only retraining facilities, but also a quick move to portable pensions, and more encouragement for technological change. The world as a whole may move towards protectionism, but I think Ontario's desperate need is to move in the other direction.

The need for adjustment and the search for security: the barriers to change

D. G. Hartle

INTRODUCTION

Canada, as everyone knows, has an open economy - perhaps the most open in the world. Changes in the world economy are therefore of crucial importance to all of us. An enormous number of dramatic economic changes are taking place simultaneously and they are closely related to a worsening international political/military situation. The two are not of course unrelated. To cite but a few examples of international economic changes:

- the decline in the value of the U.S. dollar relative to many other currencies since the early 70s (with a recent small reversal),
- the unprecedented U.S. interest rates and inflation (with a recent large reversal),
- unanticipated and unprecedented increases in the world price of oil,
- technological changes (such as transistors, fibre optics, communications satellites, computers, genetic engineering, and lasers),
- the availability of minerals from the ocean,
- the GATT agreement,
- increasing competition from pulp and paper production in the southern United States and Brazil,
- the near collapse of the U.S. auto industry,
- fears of nuclear energy and acid rain,
- the increasing importance of multinational corporations.

The list could be extended almost indefinitely.

Let us suppose there were general agreement that three types of external economic changes could be distinguished:

a) those of a short-run or cyclical nature that should be ridden out, where 'leaning against the wind' would be appropriate;

b) those that could be expected to have major long-term negative effects on particular existing Canadian industries, where abandoning them or phasing them out would be appropriate;

c) those that could be expected to have major long-term positive effects on particular Canadian industries, extant or potential, where government encouragement and support in one form or another would be appropriate.

For simplicity, those external changes where massive adaptations of existing industries would be appropriate can be thought of as the simultaneous adoption of strategies (b) and (c). It should be pointed out that the idea of abandoning, phasing out, and phasing in whole industries is also a gross simplification. The concept of an industry is necessarily arbitrary. Rarely if ever are all of the firms deemed to be members of an industry homogenous in all respects. The application of a common policy or common groups of policies to a so-called industry would therefore have differential impacts on the member firms. The decision to 'phase-out' an industry, for example, should be interpreted as a short-hand way of saying that a policy or set of policies would be adopted that would result in a gradual closing down of the marginal firms in the industry. The more severe the policies adopted the further the margin would recede. Unless the policies were draconian, one might expect that at least a few firms that had special advantages of one kind or another would survive.

For want of a better name I will designate as an industrial strategy a government policy, or set of policies, that carried out the foregoing tripartite categorization and implemented each of the appropriate responses. The very term 'industrial strategy' is enough to raise the hackles of most academic economists - including mine. This hostility has two explanations.

Virtually all of the demands for an 'industrial strategy' - and there has been a plethora of them in Canada over the past decade - turn out to be neither more nor less than demands for increased tariff protection or other concessions for virtually every Canadian industry. I have yet to see one that suggested that an industrial strategy should or would necessarily encompass the closing down or phasing out of an industry, even in the qualified sense above. My use of the term is therefore no doubt idiosyncratic. But at least it has the virtue of not pretending that

the simultaneous adoption of every special concession ever demanded by every industry would constitute an industrial strategy.

In fact Canada already has an implicit industrial strategy. It is embodied in the existing tax, expenditure, and regulatory systems. These systems are replete with positive and negative incentives that have differential effects on particular industries. Some of the incentives and disincentives are complementary, that is to say, mutually reinforcing; others are offsetting. The strong suspicion that the net effect of the whole set of government policies as they impinge on particular industries is more by accident than design is, of course, greatly disturbing to those with faith in the efficacy of rational, explicit economic policy-making. But the suspicion can neither be confirmed nor denied because it ultimately depends upon the unanswerable question of intent.

Putting to one side the entirely self-serving notion of an industrial strategy, it seems to me that the symmetrical version defined above does make some sense under the following assumptions:

- that the prime objective is to maximize per capita national income (economic welfare) over time,
- that with careful industry-by-industry analyses it is possible to distinguish between the three, at least with a success rate greater than random selection,
- that the likelihood that governments will revert to a minimal involvement or neutral stance and let the market work without any intervention is so small that it can be dismissed out of hand.

Granted these assumptions, it is arguable that the overall result would be superior to the makeshift government support of the past in one form or another not only where it was appropriate (the 'ride out the cycle' case) and where it was not appropriate (the 'hopeless industry' case), but also where government support was appropriate but inadequate (the potential 'winning industry' case).

In my view neither the assumptions nor the conclusion are implausible (although I have serious doubts about the first assumption). However, it is only the acceptance of the last of the three assumptions upon which this paper depends. For the chief purpose of this paper is to explain why even a reasonably balanced concept of an industrial strategy based on a

few reasonably plausible assumptions is probably unattainable under the prevailing government decision-making system. Indeed, the following analysis applies not only to some grandiose industrial strategy, such as the one defined above, which would purport to deal with all significant external changes. It has relevance as well, I believe, to the problems of adjustment to most major external economic changes with long-term implications, whether positive or negative.

Because the paper seeks to examine the political barriers to economic adustment in general terms it simplifies the exposition to conceive of the three principle types of adjustment problems or opportunities that are involved as subsets of a general set of government policies. It must be admitted that the designation 'industrial strategy' was selected partly mischievously and partly seriously. Those who have adopted the fashionable term as a cover for old-fashioned self-interest pleading deserve to be twitted. The transparency of the ploy is insulting to the intelligence. There are many others, however, who persistently demand the adoption of an industrial strategy because they appear to believe it would be good for the country. By using the term industrial strategy I hope to be able to capture their attention and thereby make some small contribution to their understanding of the reasons why their pleas have gone unanswered. We all have an inclination to judge politicians and bureaucrats who do not follow our advice as either stupid or malevolent. I attempt to explain later in the paper why, in a peculiar sense, the problem is more serious then the personal limitations of some of the actors and is better understood in terms of the fundamental incentive structure embedded in the existing decision-making process.

I would now like to turn to a discussion of the second type of objections alluded to above. Many economists strongly object to the notion of <u>any</u> industrial strategy that would interfere with market adjustment processes whatever the source or magnitude or kind of shock involved. Their concept of the optimal 'industrial strategy' is no industrial strategy. That is to say, they advocate both the elimination of all tariff barriers and the implementations of minimal, industry-neutral, tax, regulatory, and expenditure regimes. In other words, they assert that the third assumption above, the persistance of massive government industry-specific intervention, is inconsistent with the first assumption, the maximization of economic welfare/per capita national income over time.

No doubt it has proved useful conceptually for economists to adopt as the central objective the optimization of economic welfare/per capita income. This permits the logical derivation of the implications of alternative market structures, for example, or the consequences of changes in final demand or factor prices or technology under given market structures. By focusing attention on this single objective economists are uniquely qualified to analyse the economic welfare cost implications that may be involved in the pursuit of other objectives. Drawing attention to these tradeoffs is extremely important. Some of them are by no means either obvious or insignificant. Too frequently neither the policy-makers nor the electorate are aware of them. Too frequently also, when governments are aware of these tradeoffs they try to downplay or suppress them.

What is troublesome is the situation that arises when economists make normative pronouncements about policy matters without explicitly acknowledging either that they are based on normative assumptions or are held as articles of faith or that their assertions that the welfare costs of doing so and so are too high or too low or just right are based entirely on their personal preferences. In analysing the opportunity costs of alternative policies economists presumably have a comparative advantage. Obviously this does not hold for their beliefs or preferences.

Over the past decade or so there has been an increasing disenchantment with the efficacy of government economic policies. The reasons are many and varied. The degree of disillusionment also varies widely from individual to individual: many who complain vociferously about government intervention are quick to demand more of it when their interests are threatened or opportunities for gain are perceived. Nevertheless, most would agree that as a consequence of the disillusionment there seems to have been a perceptible shift to the right in public attitudes. The old conservative injunctions, now based on more finely honed arguments, that call for minimal government have regained considerable popularity and have been dubbed 'neo-conservatism.' Despite this recent enthusiasm, I believe political intervention is not only here to stay but is more likely to increase than decrease, although its form may well alter to give the appearance of change. The purveyors of neo-conservatism are, I believe, either flogging an admittedly intellectually majestic dead horse or in some instances providing a convenient rationale for those individuals and groups who find it helpful when pursuing their own special interests. In my experience the

astute pursuit of self-interest frequently involves the expedient adoption of alternative ideologies. Be that as it may, because this paper is predicated on the assumption that government intervention is not going to go away, I would like to try to explain this quasi-prediction.

In the classical economic model the state provided what have come to be called pure public goods. The most important such 'good' was the maintenance of property rights by the military and the police. The initial distribution of these rights (resource endowment) was taken as given, as was the institutional framework - the rules of the game, so to speak. Interrelated labour, capital, and goods markets allocated resources efficiently by virtue of the invisible hand - the pursuit of self-interest by all the actors. This inexorably resulted in the 'survival of the fittest,' and conversely. It also meant, within the classical framework, that the consequent changes in the distribution of income and wealth simply reflected the natural rewarding of the fittest and the perhaps unfortunate, but nevertheless inevitable, punishment of the unfit.

This line of argument contains a mixture of fact and fiction (ideology). Most would agree that most of the time most individuals pursue their self-interest, broadly conceived. Most would agree that most of the time private markets do provide an efficient method of allocating resources, in large part because decision-making is decentralized. This is possible because market price changes convey much information at relatively little cost. They can signal that without behavioural adjustment losses will be sustained or opportunities for gains missed. Either 'concentrates the mind wonderfully,' as Samuel Johnson said in another context. Decentralized decision-making also bestows the widest range of individual choice <u>within the individual's resource constraints.</u> This is highly valued by most individuals, at least in our culture.

The fiction aspect of the argument is the implicit assumption that those who lose either deserve or somehow were destined to lose. This, of course, is ideology: a matter of belief. For not only do the incompetent, short-sighted, and lazy lose ('the unfit') but so also do those who begin life with relatively small resource endowments[1] and those who are, quite simply, unlucky. The same is true of the 'winners,' the so-called fittest.

1 In this context the term 'resource endowment' is used to denote such diverse items as genetic inheritance, quality of family life, and the social status of parents, as well as tangible property rights.

Some begin with a relatively large resource endowment and/or are fortunate to have gains bestowed upon them by unanticipated events over which they had no influence. Unique events occur, (e.g. the U.S. defeat in Vietnam, the persistence of the OPEC cartel, and the Iranian hostage situation) that the most perspicacious and diligent of individuals could not reasonably be expected to anticipate. These kinds of events generate capital gains ('winners') and capital losses ('losers') on random basis. Nevertheless, this ideology, coupled with suffrage stipulations that excluded non-property owners, was sufficiently persuasive to reduce for decades the electorate's demand for government intervention.

It is not the purpose of this paper to argue the pros and cons of the ideology. Suffice to say it has gradually lost its persuasive power. The horrors of the industrial revolution in eighteenth and nineteenth century Britain, the excesses of the American 'robber barons' in the late nineteenth century, and the consequent development of a powerful, organized labour movement, the first world war, the depression of the 1930s, the second world war, the extension of the franchise, and many other factors all led to increased government intervention.

The institutional framework - the rules of the game - can no longer be taken as given. Indeed, obtaining favourable discretionary decisions from government under existing rules or obtaining favourable changes in those rules is now an extremely important aspect, and in some instances the most important aspect, of present-day entrepreneurship.

In short, investing time, energy, and money in obtaining a favourable decision from government can yield a high return, and in some instances a much higher return, than a conventional investment in human capital or physical capital or financial assets. There are now, so to speak, two coexisting types or markets: a political market and an economic market. Under some circumstances investments in the former yield a higher return than investments in the latter. More particularly, investments in the political market can create major gains in the economic market. Of greater significance for this paper, political investments can ensure that earlier gains are consolidated in whole or in part despite adverse external changes without precluding future additional gains.

In this context the concept of a political market should not be narrowly construed. It is not restricted to the competition among political parties for votes and the competition among the politicians in each party

for elevation to and in office, although that part of the political market is emphasized here. It also encompasses the investment made by groups of individuals in securing favourable rules and favourable decisions under existing rules within non-governmental organizations. An example of the latter would be the pressure for a seniority rule within a trade union, or the pressure by executives for a reorganization within a large corporation that would have as its unstated purpose the expansion of a unit's jurisdiction and hence promotion in income and power (status) for those associated with it at the expense of others in the organization. The non-government political (organizational) market is not considered in the balance of this paper for reasons of brevity rather than irrelevance.

In the first draft of this paper I wrote a long and inescapably turgid analysis of the protracted debate among competing schools of economists concerning the appropriate rule of government in the economy. To simplify to the point of absurdity: on the left there are those who argue that market imperfections of a myriad types are ubiquitous. This entails that government intervention is essential to maximize welfare. This group accepts the proposition that it is not only proper but highly desirable for governments to sacrifice some aggregate income, if necessary, to obtain a more equitable distribution of income.

On the right are those who argue that the importance of market imperfections are exaggerated (Stigler and others), that government attempts to correct for them are counterproductive (the costs outweigh the gains), that ologoplistic and monopolistic industrial structures are efficient when information and negotiating costs (transaction costs) are taken into account (McManus), that most policies, including attempts to redistribute income and wealth, are pointless because they are anticipated and capitalized.

And one could go on and on. But ultimately one has to face the question: so what? In the final analysis, economists on the right are advancing arguments in support of the proposition that governments should not seek to alter the distribution of income and wealth. Those on the left are arguing that they should. (Although seldom made explicit, it is important to recognize that in our culture income and wealth are to a considerable degree proxies for power and social status.) With the passage of time and much intellectual effort the arguments on both sides certainly have become more sophisticated. But the fundamental question has not

changed for centuries. The 'answer' ultimately lies, one might suppose, in one's personal values rather than in analysis. To be entirely pragmatic, consider the following facts:

- Governments in all countries throughout the world intervene in economic affairs substantially and persistently.
- Economic history strongly supports the proposition that the idealized free market system in Britain in the nineteenth century was a peculiar aberration. Indeed, to a considerable degree it was not as unfettered a market system as some now believe it to have been.
- With universal suffrage in democratic countries that aberration, to the extent that it existed at all, will not be replicated: low-income voters will never acquiesce in a reversion to a laissez faire approach to income distribution by governments.
- Most middle class voters, hostile as they are towards governments at the moment, are heavily dependent on government intervention for their income and wealth. They would be the first to scream if governments withdrew the benefits they now derive from intervention.
- Most individuals are risk-averse when the stakes are large relative to their comprehensive net worth (defined as the present value of the expected flow of disposable income, both psychic and real). Buying a few lottery tickets - buying a right to a dream if you like - is one thing: gambling with one's livelihood is another. For each individual the optimal set of government policies will be one that secures all present gains without precluding future gains, while at the same time denying the same security to all others. Protection for me and competition for you would be ideal. I would then sell at high, stable prices and buy at low and preferably declining prices.
- When a problem arises, the competition among political parties is such that the response 'nothing can be done' is suicidal. As I seek to explain in the next section, virtually all of the incentives that impinge on the personal interests of the individuals engaged in the policy-making process induce them to at least give the appearance of acting to serve the interests of significant numbers of marginal voters. Morever, generally speaking they must appear to be acting more forcefully and effectively than would their political opponents. This means that when external shocks with potentially adverse effects hit these groups of voters,

ministers dare not adopt a non-interventionist strategy. That the policies may in fact be ineffective or indeed perverse in terms of aggregate economic welfare is largely irrelevant in the political-bureaucratic-special-interest groups calculus.

There is still a demand (although I think it is fast diminishing) for deregulation. And there certainly is great pressure on government to cut back the bureaucracy, tighten unemployment and welfare schemes, and reduce deficits. I would not be surprised to see the federal government take some nominal steps in most of these directions to give the appearance of responding to current voter sentiment. We might well find, for example, that inoperative regulations are ruthlessly jettisoned, parts of government departments and agencies are converted into crown corporations to reduce the size of the public service as it is defined for statistical purposes and to shift borrowing so that the net cash requirements of the government itself are reduced. Unemployment insurance may be tightened, pushing more individuals onto provincial welfare rolls (half of these provincial welfare costs are borne by the federal government through the Canada Assistance Plan).

Parenthetically, perhaps attention should be drawn to one delightful irony: neo-conservatism has been relatively successful, at least temporarily, in restricting the scope for monetary and fiscal policy. The money supply should grow at the same rate as potential output: the federal budget should be balanced. These two rules are now widely accepted and therefore restrain politicians. But by greatly restricting the use of the two macro levers, ministers in their search for a response to voter-perceived problems are going to have to rely increasingly on micro-interventionist policies. Most would agree that these inhibit markets from performing their allocative function to a much greater extent than the deployment of the macro policy levers. It should not be inferred that this is a testimonial to the efficacy of fiscal and monetary policy instruments as they were actually deployed in the past.

It is my conviction that there are so many marginal voters (the only kind that count in the final analysis) and so many powerful special interest groups (whose continuing support is crucial to the government of the day) who now have such an enormous stake in existing forms of government intervention in the economy that a return (if it ever existed) to the neo-

conservative ideal is out of the question. Furthermore, as emphasized in the next section, I see no reason why the persistent demand for more intervention will abate as long as there is a competitive rate of return to be had through investments in the application of pressure to the political decision-making process. When major shocks of external (or internal) origin occur that would have adverse long-term effects on one or more Canadian industries, the payoff to the potential losers of an investment that secures a policy change that forestalls the adjustment could be extremely large. Similarily, an investment in securing a government decision to underwrite, in one form or another, ventures that would, for example, take advantage of technological developments of foreign origin could be remarkably profitable. For the government's part, to acquiesce in the force of pressure is not a sign of weakness: rather it reflects the never-ending conflict-resolution process that is the essence of any political system. In each instance a kind of exchange takes place in the political market between the favour-seeker and the favour-grantor. To a brief description of this political market attention is now directed.

THE BASIC CHARACTERISTICS OF THE POLITICAL MARKET[2]

It is not possible within the short compass of a section in a paper to do more than provide a sketch of a sketch of the political market. Political markets are probably at least as complex as economic markets. However, it also is not possible to discuss, as is done in the next two sections, what I perceive to be the political barriers to economic adjustment without first laying some admittedly partial, even shaky foundations.

The postulate that individuals pursue their self-interest, while repellent to some observers, has proven extremely fruitful in the analysis of economic markets. The same is true, I believe, in analysing political markets. Let us assume at the outset, therefore, that for an individual who has chosen a political career his primary objective is to attain and retain the highest office in the governing party that has a clear majority. This involves a long series of steps. Roughly speaking these are: securing the party nomination election after election, being elected and re-

2 The political market considered in this section is based on a parliamentary form of government. There are fundamental differences between parliamentary and congressional systems.

elected to Parliament, being appointed and reappointed to the cabinet, being selected as party leader, winning for and through the party at least a plurality of seats and preferably a majority of seats. For the able politician following this career path almost certainly entails a considerable financial sacrifice, although some that retire early no doubt may be able to capitalize on their knowledge of the system and their high profile. The rewards to individuals in the political system take the form of psychic income: some unknowable mixture of the prestige associated with the possession and exercise of power and the self-esteem generated by perceiving themselves to be performing the task as well as or better than their competitors. It is not necessary, however, to delve into the ultimate motives of politicians any more than we need consider the ultimate reason why individuals in the investment community choose to maximize their income and wealth. It is sufficient in analysing the political market supply to assume that the interest of the individual politician is election and re-election as a member of the governing party plus elevation to the cabinet and progression through a series of portfolios of ever-increasing authority.

The political parties are in many ways analogous to oligopolistic firms that engage in non-price competition. They supply, or seek to supply, bundles of policies. The 'buyers' (voters) are, for the most part, uninformed. Party labels and the associated ideologies serve roughly the same function as do brand names in conventional markets. Brand name loyalty reduces the voter's information and search costs. It also assures a continuing basis of electoral support if the party can appear to maintain the quality of its bundle of policies within acceptable limits. Continuing the analogy, local party candidates can be viewed as franchised dealers subject to full line forcing of the most extreme form by their single supplier. While the local candidate can try to downplay certain party policy products and exaggerate others in order to appeal to local voters, in the end he must offer the party's full line of policies without addition or deletion. Although it differs from party to party, the few active members of the local riding association and/or the provincial/national party associations seek out and offer the party franchise to individuals who are most likely to be able to sell the party's line of policies to the largest number of voters in the riding. Those dedicated to a political career will, however, actively seek the nomination (franchise) of the party they believe most

likely to afford the career opportunities discussed above.

The cabinet consists of a subset of the successful franchise holders of a party that has just succeeded in attaining a plurality or majority of seats. The party organization has just served its principal purpose - getting out the vote. Those members who have worked so hard in the campaign eagerly await their rewards, which may take the tangible form of appointments and contracts or the intangible form of perceiving, probably erroneously in most cases, that they have policy influence. The elected member of the governing party is expected to deliver to his principal supporters, and he cannot afford blatently to disappoint because the organization will be needed again. Cabinet ministers in particular are hardly credible when they say they are powerless to reward their principal supporters in one way or another.

Immediately following an election the influence of the party on the government undoubtedly declines drastically. Indeed, the party's newly elected MPs not selected for cabinet office by the prime minister quickly discover to their chagrin, if not despair, both that they have little if any influence on the cabinet on substantive issues and that party discipline is all-pervasive and all-powerful. Party discipline is achieved by:

- the hope of appointment by the PM to parliamentary assistantships, high-profile parliamentary committees, and eventually cabinet office;
- central party control (that is, of course, dominated by the PM) of financial and other forms of campaign support in subsequent elections;
- central party influence/control over nominations;
- peer group pressure that penalizes, above all else, disloyalty to the party that would inevitably inflict costs on other members.

In selecting his Cabinet the PM will seek to reflect, insofar as possible, the interests of the electorate: linguistic, religious, regional, sex, etc. Ideally the composition of the cabinet should reflect in microcosm the conflicting interests of the electorate. At the same time the PM requires talent to carry out the work. He cannot afford to exclude MPs who have personal political power bases. To exclude their spokesmen would offend significant groups of voters.

The cabinet government functions simultaneously on an adversarial and a collegial basis. Leaving aside the members responsible for the cen-

tral agencies, about which more will be said in a moment, the system only functions well when individual ministers press the interests of the departments and agencies for which they are responsible and the interests they embody as individuals (e.g. region, business or labour, language, etc.). The policy initiatives must, for the most part, emanate from them. It is also true that governments are re-elected or defeated on the basis of the total package of policies. If one or two ministers are inordinately strong relative to their colleagues and are only successful in pressing the interests they represent, the full line of policies will offend the interests underrepresented and the government risks defeat. This is where the collegial dimension of cabinet government enters the picture. Leaving aside those few strong ministers who are willing to press their interests to the point of bringing down the government in the hope that they might then replace the party leader, ministers are willing to acquiesce in the balancing of conflicting interests as determined by the PM.

It should be noted, perhaps, that prime ministers who detect such rebels have many effective avenues for stifling them without resorting to blatant dismissal from the cabinet, which would radicalize their followers. Moreover, the majority of party loyalists are most unlikely to support a leadership aspirant who they suspect was responsible for the government's defeat at the polls. Because the defeat of the government means their removal from cabinet office, members of the cabinet, with the rarest of exceptions, not only acquiesce in the PM's attempt to create a balanced policy package but unanimously support that package in public.

Seen from this perspective the roles played by the ministers responsible for the central agencies is easily seen. The president of the Privy Council (the House leader), the minister of finance, the president of the Treasury Board, (and probably too the ministers of justice and external affairs, although they are customarily not designated as central agency ministers) assist the PM in producing the requisite balanced policy package. For example, with the exception of the central agency ministers, all of the others press for more expenditures either on existing or proposed programs, for more tax concessions, and for more regulations. It is necessary for them to appear to respond to problems affecting the interests they represent. Without the restraints imposed by the central agency ministers expenditures would balloon more rapidly, revenues would grow less rapidly, and the regulatory jungle would become even more

impenetrable. (I will forgo the temptation to enter into an explanation of the apparent failure of the central agencies to exert adequate control in the past decade. That would require another paper if not a book.) The ministers responsible for the central agencies have much greater clout relative to their colleagues both because they recognize that their individual survival hinges on the survival of the cabinet as a collectivity and because the central agency ministers almost invariably have the full support of the PM. They are in effect extensions of the PM. Should he falter in his support the hordes of spending and regulating ministers would quickly over-run the citadel.

The bureaucracy

The principal objective of most professional bureaucrats is promotion to positions of ever greater influence. Contrary to popular belief, deputy ministers responsible for large operational departments (e.g. Public Works, Supply and Services), where administration concerns dominate policy concerns, are treated as second-class citizens in the bureaucratic pecking order unless the appointment is perceived to be a stepping stone to one of the policy-oriented departments or central agencies.

It is important to recognize that appointments at the deputy minister level (of which there are four grades) are by order-in-council and are made by the prime minister on the advice of the secretary to the cabinet, the king of the bureaucratic castle. The appointments are made 'at pleasure,' although it is understood that the recent instances of pre-emptory dismissal without cause have led to substantial out-of-court settlements to preclude damage suits against the government. All other bureaucrats are appointed by the Public Service Commission supposedly on the basis of merit - which means through competition. The word 'supposedly' is used advisedly because for the most senior positions the views of the deputy minister are given enormous weight, as they should be. I do not wish to seem to imply the existence of improprieties. The very existence of the Commission and the competitive process rules out nepotism and most bureaucratic patronage. It would be worse than pointless for the Public Service to foist off on a deputy minister a man or woman that he could not abide or deny the deputy minister the service of the individual he believed most capable of delivering what he required. A deputy minister cannot be

held responsible for failure if he is denied the senior people he wants.

Although the merit principle, implemented in the federal Public Service around 1920, largely eliminated political patronage in appointments with the wholesale turnover of staff every time the government changed, it did create another problem. To prevent wrongful dismissal on patronage grounds an enormous number of complex and time-consuming procedural barriers were created. Unfortunately the rules that prevent wrongful dismissal also greatly inhibit rightful dismissal for incompetence, slackness, and so on. It is rarely, if ever, in the interest of the supervisor to spend the hundreds of hours under emotional strain in the hearings required to obtain the dismissal. It is much easier to try to work around the problem person.

Just as supervisors have great difficulty in 'punishing' incompetent subordinates, they can do little to reward superior performance by the incumbent of a particular position. The classification of the position determines the remuneration of the incumbent, and the scope for merit pay increases is essentially trivial. As a consequence, to attract or retain superior subordinates the conscientious supervisor must successfully press for an ever-expanding role for his unit in order to enhance the career prospects of those who work for him. The pressure to persist in empire-building is thus inherent in the implicit incentive system. It should be added that because of the merit principle and the consequent filling of positions by competition, management is precluded from assigning employees to the positions where they are most needed. There is nothing to prevent an employee who wins a competition from moving immediately from a high priority task to a lower priority task - albeit one with a high classification. To preclude such movements the supervisor must try desperately, and often to no avail, to secure a higher classification for the position in his unit in order to entice the valuable subordinate to stay - at least until some project is completed on which the individual concerned may have been working for many months. This inter-agency competition for the most competent staff, which ultimately derives from the adversarial nature of the cabinet decisionmaking process, inevitably leads to a process of self-levitation with respect to job classifications. In point of fact, therefore, except with central agencies, which are also caught up in the interagency competition for the most competent staff, in order to be successful in their own game they must press for more programs, expanded

programs, more regulation, and so on.

This pressure of course does not fully explain bigger and bigger and more and more intrusive government. Bureaucrats are compelled because of the incentive system under which they operate to try to sell expanded policy proposals to their ministers. The ministers to whom they are responsible are for the most part eager buyers. They have a strong demand for policy proposals that would, if accepted by cabinet and ultimately enacted, enhance the interests they represent by virtue of their portfolios. Ministers, again excepting the central agency ministers, could not play their role in the adversarial cabinet decision-making process unless they had a constant supply of demands furnished by their officials and special interest groups (the latter are discussed later).

In the political science and public administration textbooks a clear distinction is drawn between the roles of ministers and the roles of officials. The elected minister is ultimately responsible for all decisions: the appointed official supposedly only advises, or administers, or negotiates within ministerially determined limits. Obviously the reality is not that simple. Ideally there is a symbiotic relationship based on mutual trust. Each seeks to enhance the career prospects of the other. Each anticipates the needs of the other within his own game and tries valiantly to assist him. They are mutually dependent. When both are professionals the minister need give few formal orders, for the deputy can anticipate what he wants and act accordingly; by the same token, the deputy does not have to argue endlessly for ministerial approval of things the deputy needs to enhance his department and, 'as though by an invisible hand,' his own stature.

A few words should be said about information networks and alliances. The policy proposals submitted to cabinet by a minister represent a complex reconciliation of the following:

- the interests of the department's clientele,
- the minister's personal interests,
- the interests of departmental officials,
- the interests of other departments whose support or acquiescence at the ministerial and official level is required for cabinet approval.

Moreover, the proposal must reflect the probable attitudes of the

opposition parties and, particularly in a majority government situation, the mass media. As will be explained later, it must not offend more marginal voters than it attracts except under special circumstances. To produce such a proposal requires inflows of information from many sources, some external to the government and some internal. On the basis of this information protracted negotiations take place at the bureaucratic and ministerial levels. Logrolling is the order of the day. Alliances are constantly being formed and reformed. IOUs good for policy proposal support are constantly being issued and called in at the bureaucratic and ministerial levels. Obviously these IOU's have differing denominations depending upon the issue and the issuer. The participants in these transactions are well aware of these debts, usually without explicit discussion of the magnitudes involved. The actors have perfect recall with respect to their net IOU position with respect to each other. Heaven help those who renege when an IOU is called. Information flows cease. Alliances collapse. The policy proposals of those who have betrayed a trust are sandbagged. Careers are blighted.

Thus the rolling set of compromises among conflicting interests that is the heart of the political process begins, and often is completed, before policy proposals reach cabinet. The most successful ministers and deputies have prepared the ground so well and drafted the document so skilfully that eventual cabinet approval not uncommonly is largely a foregone conclusion, even though a lengthy debate on the proposal may take place within cabinet.

Special interest groups

Although party organizations play an indispensable role at election time, and some nominal attention must later be paid to the resolutions passed by party conventions to avoid disaffecting the faithful, in the post-election period the influence of special interest groups comes to the fore. With minority government, however, this influence is greatly reduced because one or other of the opposition parties has to be placated, and powerful, prying parliamentary committees pose problems. With majority government, however, special interest groups can and do exert great influence on policy decisions.

Many American political scientists, dubbed 'pluralists,' have in the

past taken the view that because there is such a large number of such groups and because their interests are often in conflict, they essentially negate one another. This is, if you like, the notion of countervailing power. By this line of reasoning, the preferences ('will') of the electorate, as reflected in the preferences of the elected members, are not subverted by powerful lobby groups. For each interest group pressure it is assumed that there is an equal and offsetting pressure from one or more other groups with the result that the final policy outcome is unaffected.

This is an extraordinarily sanguine view of the political market and can be easily rebutted. As Mancur Olson pointed out, all interest groups are subject to the 'free rider' problem. The nature of the problem is straightforward. Suppose there are ten individuals who share a common interest in, say, a favourable change in a tax provision that, if enacted, would be worth the present value of $1 million a year in perpetuity to each of them. Expenses incurred to obtain the change, up to this potential benefit per member (appropriately discounted for risk), are a worthwhile investment. If the potential benefits exceed the costs the individuals concerned cannot afford not to organize, hire professionals to prepare briefs and PR materials that will lead to a favourable media response, lobby officials and ministers, and the like. Some prior discreet, indirect (goods and services in kind) campaign support would not have been amiss either. The implied (contractual?) promise of future support might do almost as well.

Let us further suppose that the $10 million in annual revenue that would be forgone if the proposal were implemented would be recouped by raising the annual taxes of a million individuals by $10 - again in perpetuity. Assuming that the losers are aware of their loss, it would not make sense for any one of them to spend more than the present value of $10 a year in forestalling the change, a relatively modest amount at present interest rates. Furthermore, and this is where the 'free ride' comes in, the vast majority of the potential losers would almost certainly not contribute to a counter campaign on the obvious grounds that his or her prorata share of the cost would be such a small fraction of the total that it would not be missed. Why pay when others will? The result is that the opposing interest is either never organized or soon collapses for want of financial support, particularly if the debate can be protracted.

The larger the total stake, the smaller the number of members of the

group, the greater their concentration (such as by geography, industry, or occupation) the less formidable the free rider problem. Self interest can be reinforced by social and other pressures. The converse is also true. Consumer groups, environmental groups, civil rights groups, broadcast listener and viewer groups, cable and telephone subscriber groups, to name only a few, tend to be in perpetual financial trouble and cannot afford the quantity or quality of professional support (a few martyrs excepted) that the interests they oppose are able to deploy over sustained periods. Even assuming that only a positive sum game were involved, that is to say, the losses (potential gains) to the narrow group would be less than the gains (potential losses) to the larger group, surely few would argue that the smaller groups would be more likely to be victorious most of the time.

In my view ministers and senior officials give great weight, at the time and under the circumstances I have described, to narrow interest groups for some or all of the following reasons:

- Most such groups constitute a significant client of a particular government department and hence a particular minister. The interests of the bureaucrats and the minister are served by pushing the interests of the client group.
- The department and its minister are usually heavily dependent on such groups for information. This information, needless to say, is seldom unbiased. Much of it is conveyed during social functions arranged by the group. A degree of social rapport develops that reinforces the advocacy of the group's position. Such groups gain insider information that allows them to adopt effective strategies, not only with respect to the particular department but more generally.
- Organized interest groups hire lobbyists and/or a permanent 'association' director with an Ottawa office. They make it their business to become acquainted with the principal actors - political and bureaucratic. By these means the group has quick access to the right people at the right time.
- Special interest groups can and do retain professionals to prepare an endless stream of briefs, reports, studies, and letters. When public hearings or proceedings are involved they retain the services of highly trained and paid legal, accounting, and technical experts to appear and

intervene on their behalf. The longer the proceedings the greater the group's advantage relative to public interest groups that perpetually struggle with a thin purse and with activist members whose enthusiasm tends to lag as the proceedings drag on. The professionals working at high per diem rates have unflagging energy.

- One would have to be somewhat obtuse not to come to the view that there usually is a sometimes explicit, sometimes implicit, informal contractual relationship established between interest groups (or the individual members of such groups) and one or more ministers and/or senators and/or party executive members and/or, perhaps more rarely, senior officials. The group's members have needs, and the individuals in positions of power or influence have needs. Although one might hope that in Canada out-and-out bribes are infrequent but not unknown (e.g. Skyshops), interest group members can and do make contributions in cash or kind to individual candidates seeking nomination, to party war chests, or to income supplementing trust funds for prominent politicians. Former ministers are appointed to well-remunerated corporate directorships and the like.

I do not wish to imply that there is necessarily anything immoral about these kinds of (often delayed) exchanges. Much less should it be inferred that they are illegal. The point is simply that large, amorphous, and dispersed groups, such as the Consumers' Association of Canada, are certainly not in a position to compete in this quid pro quo game.

In the contest for favourable media attention this imbalance between narrow and common interest groups seems to be partially rectified. But before proceeding to that subject I shall reiterate my theme: narrow interest groups can and do invest in obtaining favourable changes in statutes and regulations (generically termed rules here) and in obtaining favourable decisions under existing rules both by applying pressure on the sensitive points and by trading favours for favours with those in positions of authority. Now to the media question.

The media

Journalists, to use the term in the broadest possible sense, have a most significant and probably grossly underestimated impact on public policy decisionmaking. For the vast majority of voters, 'reality' is what they see

and hear on television and skim read in papers such as the Toronto Sun and the Star. For politicians, voter perceptions of reality, however distorted, limited, or even erroneous, are the only reality.

The media play a vital role in the decision-making process that is frequently underestimated by those not actively engaged in it.[3] To an important extent, journalists (to use the term in the widest possible sense) define the problems to which the competing political parties must respond. Similarly, they describe and interpret those responses to the electorate and thus can significantly affect electoral outcomes. To a remarkable degree, 'reality' for all of us is what television, radio, newspapers, magazines, books, and film say that it is. Certainly that is the politicians' reality in the sense that the electorate's perceptions of them and their actions is at least as important as who they 'really' are and what they 'really' are doing.

It is true, of course, that an infinite number of realities can be found in the media, where freedom of expression prevails. The reality of the Globe and Mail is markedly different from that of the Toronto Sun. In instances where both cover the same event, the facts may well be the same but their interpretations are likely to be markedly different. Perhaps more striking, however, is the disparity between the two with respect to the selection of the events to be reported and the relative importance attached to them. The same can be said, however, about a trade newspaper vis-à-vis the Globe and Mail. Little of the information carried by the former will appear in the latter for the obvious reason that only the relatively small group in a particular trade are interested in the details of their business.

This situation is even more striking with respect to books, periodicals, and films; it is probably less so with respect to television and radio. There is not, in short, a market for information in general any more than there is a market for food in general. Neither are homogeneous goods. Rather, there is an untold number of markets each with its own clientele and suppliers. Just as with food, each individual takes some of this kind of information and some of that and combines them to satisfy his

3 The balance of this section, with the exception of the last three paragraphs, was written by the author and extracted from an unpublished paper prepared for the Economic Council of Canada: D., Hartle, M. Trebilock, et al.: 'The choice of governing instruments,' III, 31-9, March 1980.

own perceived needs and tastes. Because acquiring and assimilating information is costly in time, money, and effort, and because all these have to be budgeted, the individual must be highly selective. Using rules of thumb and scanning techniques based on training and experience, individuals narrowly restrict their intake of information. The result is that the most knowledgeable citizens have enormous gaps in their awareness and understanding of reality. The decisions of all of us are therefore based on what Herbert Simon has called 'bounded rationality.'

By definition, the vast majority of individuals obtain virtually all their current information from the mass media (we ignore conversation and observation). Leaving aside the few non-profit enterprises, the profitability of particular suppliers hinges crucially on their volume of sales or number of viewers or listeners. This results because their principal (or only) source of revenue is from the sale of advertising. These revenues depend upon the rates charged, which in turn reflect the size of the potential market reached by the newspaper, periodical, or broadcast. It is in the interest of each supplier to differentiate its product in order to increase its market share. Too much differentiation obviously will have the opposite effect, for the market will become too narrow because of 'undue' specialization. This does not preclude the existence of profitable, smaller audience publications or radio stations that reach particular markets to which some advertisers especially wish to appeal and who therefore are willing to pay higher rates for that access. Nevertheless, the information conveyed in these segments of the media is rarely the stuff that shifts the party preferences of a significant number of marginal voters in marginal ridings. In what follows we will ignore these highly specialized media. It should be noted, however, that it is not only possible but common that at least three levels of information on the same subject exist at the same time. Suppose, for example, that a particular, relatively small industry is pressing for tax relief in the form of a higher rate of writeoff for corporate tax purposes of a type of equipment unique to the industry. There will be private communication among the industry leaders and between them and the government; there also may be at the same time extended articles on the topic in the trade magazine; there may be a brief news item in the mass circulation newspaper reporting a speech by the trade association chairman. Were the concession to be granted, the same degree of emphasis would be accorded to it in each of the three

levels. The immediate beneficiaries would be well aware of the triumph; other taxpayers are unlikely to be aware of the cost they would have to bear.

The objective of media management is straightforward enough: profit maximation. The objective of most journalists, one might assume, is for maximum public recognition: bylines, columns, talk shows, and so on. Such journalists can command higher income and 'perks' from competing managements in the mass media - managements that can use such journalists to attract more readers, viewers, and listeners. As a consequence, the incentive system in journalism is such that the profession implicitly penalizes those members who specialize in covering complex policy issues. The investment of time and effort is high but the payoff is small because the audience is small.

Globe and Mail columnist Geoffrey Stevens in an article entitled 'The case of image over reality,' (23 February 1980, p. 10) quotes with approbation a candidate, Marcel Masse, who stated, just before the election of 18 February that 'I've always been a constituency guy, but there's no room for me now.' Stevens went on to comment:

> Most M.P.'s won't admit this. They like to think they got elected by dint of hard work or personal appeal. The backroom boys, however, say that the national party, its policies and its organization count for nearly half of a candidate's support and the leadership or the image of leadership also counts for close to half ... A typical candidate is worth between three to five percent - no more.

After discussing the distorted images of the two principal leaders conveyed to the public in the election, Stevens said:

> It would be bootless to blame the public for not seeing through the distorted images of the leaders. The responsibility starts with the mass media. The media may not have invented the images, but they nurtured and fed them ... Television is the chief villain. It is the most compelling, believable media and the most superficial. Television is the perfect vehicle for reinforcing images ... Television is a terrible vehicle for contradicting conventional wisdom, for revealing how a politician really thinks and what he really believes.

The columnist then discussed, among other things, the common misapprehension that what is seen with one's own eyes on television is true while what one reads may be misleading.

Stevens article makes three points that I believe to be of great significance. First, especially since the advent of television the particular qualities of local candidates for the competing parties are of little importance - a vote for a candidate is usually a proxy vote for a particular leader and/or party and/or set of national policies; the different images of the party leaders may be as important, or more important, than the differences in the policies for which they purportedly stand; although the medium perhaps is not the message, as Marshall McLuhan would have it, certainly visual media convey some kinds of messages better than others, and the comparative presentation and analysis of the policies of the competing political parties is poorly communicated on TV. Since most of the population spend much more of their time watching TV than reading even a newspaper, it is hardly surprising that, to the limited extent voting decisions are determined by party policy differences, they are for the most part based on a few issues that have been grossly and often misleadingly simplified.

This situation lends itself to another relationship - a relationship that is sometimes symbiotic and sometimes the antithesis. The mass medium journalist works under an incentive system that greatly rewards the revelation of the sensational and the trivial, together with the soothing confirmation of prior belief. Complexities, ambiguity, generality, paradox, and uncertainty, although painfully prevalent in the real world, must be suppressed or perhaps converted by art or artifice into simplicity, clarity, specificity, answerability, and certainty. The vast majority of viewers/listeners/readers want all things on their information menu to be black and white, true or false, good or bad - preferably seasoned with a pinch of sensationalism and intimate personal detail of the famous, and served on a platter of conventional belief. The successful journalist must take the raw ingredients - the issues of, and the actors in, the policy decision process - and by chopping, grinding, mashing, blending, baking, boiling and frying, convert them into attractive food for the average palate. This pleases the patrons, and that pleases the media owner.

The policy-maker is therefore faced with the sad fact that his words and actions frequently are hopelessly misconstrued or distorted. Some 'good' policy options may have to be rejected simply because they would never be explained to most voters. They would <u>look</u> 'bad.' Conversely, 'bad' policy options may have to be adopted because they would <u>look</u>

'good.'

Politicians are quick to assert that the rejection by the public of a particular policy (or government) is or was the result of a misunderstanding, when the fact is that the public understood it all too well. There seems little doubt, however, that such misunderstandings, or perhaps more accurately incomplete understandings, do occur because many journalists are not fully informed themselves or do not have the skill or will to convey the information to a reluctant market. This phenomenon, coupled with sensationalism and trivialization, means that policy-makers are to some extent forced by the media to submit to 'irrational' constraints, and sometimes they are subjected to criticisms that are founded on ignorance or misleading information that in an ideal world the media would dispel or correct. This raises a question that is as important as it is imponderable. To what extent are the weaknesses of the media capable of amelioration and to what extent do they simply reflect the limitations of their several audiences?

The other side of the coin is that the mass media can be exploited at times and to a degree by politicians and special interest groups. By 'exploit' I mean they can take advantage of the weaknesses of the journalists as human beings and/or take advantage of the limited time and other resources they have at their disposal.

Lazy or overworked journalists are prone to accept press releases and stories at face value and submit them to their employees without cross-checking or critical assessment. Venal journalists can be made more sympathetic by lavish entertainment or gifts or overly generous moonlighting contracts. Vain journalists can be flattered and their critical faculties dulled.

Important and controversial policy decisions can be buried in complex amendments to complex statutes. 'To get to the bottom' of the issue might take the journalist much more time, effort, or expense than he can devote to it because of other demands. Moreover, such investments are highly speculative; with all the relevant information at hand, there may be no story, or the story may be of such limited interest that it would be pointless to submit it. Similarly, the government may announce a particular policy that sounds eminently sensible, even appealing, duly reported. But it is a rare journalist that later seeks to discover what was actually implemented and what were its ultimate effects, unless of course he is given

some lead.

The reasons for the lack of followup are obvious: the opportunity costs are high and the payoff uncertain. Nevertheless, the politician can take advantage of these phenomena and thereby create the illusion of problem-solving. In other words, politicians can 'dupe' the electorate by exploiting the limitations of the media that to some indeterminate degree are reflections of the nature of human perception and motivation. Because of the competition among the political parties, if one party finds it expedient in its pursuit of electoral success to try to exploit these limitations, the other parties have no alternative but to follow suit or expose it. Casual observation would suggest that political parties believe that positive policy alternatives usually attract more marginal voters than criticism of opponents.

To revert to the interest group issue: another form of investment that narrow interest groups can make is to hire journalists and public relations specialists to write and plant in the mass media items favourable to their cause. Such 'stories' can create a more receptive attitude to government rule changes or decisions that may in fact not be in the interest of most voters.

The narrow interest groups seek to 'soften up' hostile voters through the media in order to reduce the political costs that ministers would face by acceding to their pressure or by resisting demands for 'reform.' The public interest groups on the other hand seek to use the media to convince the electorate that they should demand of the government a withdrawal of earlier concessions or resist further advantages or impose additional costs on the narrow special interest groups.

In this arena, as indicated above, the broadly based collective interest groups may well have an advantage. The media are probably considerably more receptive to human interest stories and to environmental degradation, consumer exploitation, and civil rights arguments than they are to the seemingly self-serving positions of the narrower groups frequently perceived as villains. The groups that suffer the most from the free rider problem have a partially countervailing advantage because the public is more sympathetic to their cause and they are treated more receptively by the media.

Marginal voters in marginal ridings

In the preceding discussion of the role of the media in the decision-making process it was emphasized that information costs, in terms of time, money, and effort, are high. It is perfectly rational therefore for individual voters to be largely uninformed on most public policy (and other) issues that they do not expect either to affect their own interests materially or that they cannot influence materially. The news media, in their competition for advertising revenues, must take the resulting preferences of their potential readers, listeners, and viewers as given. Up to a point political parties must do likewise. However, as the expenditures on commercial advertising amply demonstrate, there is considerable room for persuasion particularly when buyers are uninformed. It is important to recognize that the rational ignorance of most voters about most policy issues has some advantages for a political party in power faced with the never-ending task of resolving the conflicting interests of groups of voters. It is imperative to recognize, moreover, that from the point of view of the competing political parties all voters are not equal from a policy decisionmaking point of view.

Both marginal and intramarginal voters and marginal and intramarginal ridings must be distinguished. An intramarginal voter is defined as one who is sufficiently committed to a particular party that only an extraordinarily large gaffe by that party on an issue about which the individual had a strong preference would induce him or her to switch to one or other of the competing parties. This party attachment is what Hirschman calls 'loyalty.' As he points out, even when affronted by the party, such individuals are more likely to stay and fight (adopt the 'voice' option) than bolt (adopt the 'exit' option) if they see any likelihood of changing the party's stance on the issue. Obviously, party commitment is a matter of degree rather than a difference in kind. Nevertheless, the black-and-white distinction simplifies the exposition without changing the basic argument.

The essential point is that at election time committed voters are of little interest to any party. Committed supporters, however, certainly should not be antagonized. Certainly, too, some symbolic reassurances should be offered. But that is all. Similarily, there is no point in appealing to the committed members of other parties either. Moreover, when

the proportion of voters committed to a particular party in a particular riding is sufficiently large to nullify the votes of the marginal voters in that riding, the whole riding can be largely ignored. Henceforth I will use the term marginal voter to refer only to marginal voters in marginal ridings.

There are, as we all know, negative, zero, and positive sum policy change games. Looked upon from the olympian heights of the total interest of the nation, and making the strong assumption that the degree of satisfaction of each individual is unaffected by the income-consumption of others (there is neither jealousy nor pity), negative sum policies (costs exceed benefits) are bad by definition; zero sum policies (costs equal benefits) are a matter of supreme indifference; positive sum policies are good by definition (so-called Pareto optimality). With positive sum policy changes losers can be compensated, and a net benefit is available that can be used to make one or more persons better off. This line of reasoning, which has formed the basis for welfare economics for many decades, is ultimately totally irrelevant for at least two reasons. The fundamental assumption that my satisfaction is unaffected by what I perceive to be the satisfaction of others is much less plausible than the converse. Human history is replete with wars, revolutions, and the like, which can only be explained by jealousy and/or empathy. Individuals act within both the economic and political markets to improve their <u>relative</u> positions, and the relative positions of those for whom they care, even if this means some reduction in the absolute level of income/wealth. Absolute levels of consumption are obviously of absolute importance when they hover around the level of <u>physical</u> subsistance. Beyond that point, however, concern with relative position - status if you will - is so significant that to ignore this dimension of decision-making at the individual and collective levels is not an ingenious and fruitful simplification but the transformation of a true problem into a non-problem. Moreover, the standard of Pareto optimality is of course an ethical postulate rather than an assumption about reality.

The second reason I would advance for rejecting the 'bad', 'neutral,' and 'good' designations for negative, zero, and positive sum games (policies) derives from a straightforward fact. There is nothing in the incentive systems that dominate political markets that would lead one to suppose that the competition among political parties would 'as if by an invisible hand' inexorably result in positive sum policies driving out zero

or negative sum policies. The basis for this statement required some elaboration because, superficially at least, it would appear that if a government in office were to fail to adopt feasible positive sum policies there would be a potential net gain that an opposition party could exploit (Becker). The points set out below are put forward in rebuttal. They are not of equal weight and the sequence is immaterial.

- Elections are not referenda on particular policies; given full line forcing by competing parties, the bundle of potential policies is of infinite variety and complexity.
- A government running for re-election must live with its record. But voter memories, except on a few issues that affect them closely and deeply, apparently are short.
- Opposition parties are less burdened by their record (although the hanging of Louis Riel in the late nineteenth century and the record of R.B. Bennett in the 1930s have haunted the Conservatives to this day). They must contend with four facts: they usually do not control the timing of the election; they are less well informed on policy issues; they cannot call the IOUs they hold for past favours granted; and, most important, marginal voters tend to heavily discount electoral promises. The promise of costless benefits is treated by most thoughtful voters as worse than implausible.
- Unless there were a unanimity voting rule the likelihood of re-election or election is maximized by bestowing benefits on marginal voters and their costs on intramarginal voters.
- When specific benefits are given to narrow groups of marginal voters they are likely to be fully aware of the gain. When their cost is spread widely and hence thinly - preferably among intramarginal voters but if necessary among some marginal voters too - they are unlikely to be aware of the loss because they are, as I have argued, rationally ignorant on most policy issues. Furthermore, because the costs per policy per voter are relatively small they are not likely to induce intramarginal voters to reconsider their party loyalty even when they are aware of the burden being placed upon them.
- In the unlikely event that the losers become aware of their individually small but in some instances collectively large losses, there is the 'free rider' problem that they face in pressing for redress outside the

electoral system.

- Given (a) the seemingly infinite number of policies and programs in contention and their mind-boggling complexity in many instances, (b) the uncertainty about how other marginal voters will actually cast their ballots in the privacy of the polling booth, and (c) the uncertainty concerning how each party will behave if elected, surely it is true that most marginal voters cannot make a careful, detailed calculation of the implication for their own self-interest of casting their ballot for a particular party. Is it surprising, therefore, that faced with such a dilemma many and perhaps most marginal voters now vote for the local candidate as a proxy vote for the party <u>leader</u> they find most appealing or least unappealing? The advent of TV, which can create the illusion that the contending party leaders are present in the voter's living room, means that the personal appearance, manner, and style of these men takes on enormous significance. Why not buy the used car from the salesman who looks as though he can be trusted more than the others?

The following axioms seek to capture the implications of the foregoing brief sketch of the new characteristics of the political market.

Some political axioms governing instrument choice[4]

By grafting elements of rational ignorance on the part of both voters and political parties onto the important distinctions between marginal and intra-marginal voters in the political calculus, the following axioms seem to emerge as influential in instrument choice:

1 It is in the interests of a political party to choose policies which confine the benefits to marginal voters and confine the costs to intra-marginal voters.

2 In order to overcome the information costs faced by marginal voters, it is in the interest of a political party to choose policies which provide benefits in concentrated form so that their visibility is enhanced and to impose the costs in dispersed form so that their invisibility is enhanced.

4 Ibid, IV, 34-43. These axioms were jointly developed by Trebilcock and Hartle.

3 A political party cannot choose only policies which provide highly concentrated benefits, because as the benefits become more clearly visible the smaller the group of voters on which a party can realize a political return.

4 However, it will be rational for a political party to treat highly concentrated interest groups as marginal voters to the extent that they possess an ability to provide (or threaten to provide) subsidized, selective information directly to marginal voters that might change their political preferences or to provide resources to political parties with which they can in turn either confer benefits on marginal voters or provide subsidized, selective information to marginal voters intended to influence their political preferences.

5 The more widely dispersed the group of marginal voters to be benefited by a chosen policy the less real the benefits need be.

6 Perceived benefits can be made to appear greater than real benefits by the provision by political parties (typically through the mass media) of subsidized, selective information, often of a highly symbolic nature.

7 Where, in order to confer benefits on a relatively dispersed group of marginal voters, it is necessary to impose costs on a relatively concentrated group of marginal voters, it will be in the interest of a political party to choose a policy instrument that minimizes real costs over time while obscuring the erosion of real benefits by the provision of subsidized, selective information and symbolic reassurance to the beneficiaries of continuing commitment to the initial policy.

8 Where the dispersion of costs does not fully obscure their existence from marginal voters who are bearing them, it will be in the interest of a political party to provide subsidized, selective information and symbolic reassurance to the cost-bearers to reduce perceived costs below real costs; costs will be represented, to the extent perceived, as 'sacrifices' or 'investments' made to secure long-term benefits.

9 It will be rational for political parties to choose policy instruments that confer benefits, or perceived benefits, on marginal voters throughout, or at least late in, the current electoral time period, while attempting to defer real, and perceived, costs borne by other marginal voters to some point in time beyond the current electoral time period where causal connections are attenuated, or where this is not possible to impose these costs at the beginning of the current electoral time period rather than at the end,

so that voter recollection is dimmed by time.

10 Where political parties are uncertain as to the impacts of alternative policy instruments on marginal voter interests or on marginal voter awareness of these impacts, the intensity of voter preferences surrounding these impacts, or opposition parties' alternative policy proposals on these issues and voter responses thereto, it may be rational to choose an instrument that maximizes reversibility and flexibility, so that continuous marginal adjustments in the balancing of interests can be made over time.

11 In the case of policies which impose real and perceived costs on marginal voters, it may be rational for a political party to assign the administration of the policies to an 'independent' agency of government so that the causal relationship between the costs and the party is attenuated in voter perceptions.

SOME ADDITIONAL CONSTRAINTS

The complex, interrelated rules that together determine the structure, processes, and largely implicit incentive system of the political market constrain the policy decisions reached. But the constraints described in the previous section are of general applicability. In this section an attempt is made to highlight some of the constraints that are of particular importance for the long-term industrial strategy issue. Like the previous section, the particular constraints briefly discussed by no means constitute an exhaustive list. The order of their presentation is immaterial.

Differential time horizons

As the concept of industrial strategy has been defined here, the payoff from the adoption and implementation of such a policy or set of policies would be at least five, and more likely ten to fifteen, years down the road. The costs, as explained later, would be almost immediate. In considering the political feasibility of such a strategy, it is imperative to contrast this time horizon with the time horizons of those who ultimately must make the decision to press ahead, postpone, or reject it.

As is well known, the term of a majority government cannot exceed about five years, and with a minority government the term can be much shorter than that, as we have been recently reminded. Even with a

majority government, one would expect that it would strive valiantly to have put together within the first three, and at most four, years in office the optimal full line of policies that the ministry/party could place before the electorate. To delay beyond that date would reduce, and eventually eliminate, the tactical advantage of the party in power of being able to call the election at the most opportune moment (Breton). Again, Canadians generally, and political parties particularly, have been recently reminded of the possible consequences for a party when it loses this tactical advantage.

The bundle of policies will be optimal from the point of view of ministers when it maximizes the likelihood of their re-election with the largest number of seats. Within this time frame, adoption of an industrial strategy as we have defined the term (a comprehensive list of both potential winning and losing industries) would be extremely unattractive politically. Perhaps the announcement just before an election of the intent to introduce such a strategy, without the disclosure of the designated industries, might on balance appeal to marginal voters. But if enough information were provided to give the electorate the impression that the government had finally come to grips with the issue it would be necessary perhaps to disclose that there would be losers as well as winners. Certainly this would raise the uncertainty level of voters. Whether or not the voter expectations generated would be primarily positive or negative is a moot point. It is more likely, one might suppose, that the pre-election promise would be so vaguely worded that it would be largely discounted as election rhetoric.

The enactment and implementation of such a policy would be quite another matter. This would involve the establishment of agencies, procedures, and a program budget. As explained later, endless negotiations would be required. Staffing and the preparation of international industry analyses would be time-consuming. It would quite likely take several years before particular industries were even designated. Immediately the atmosphere would be acrimonious. The designated losers would, unless compensated over-generously, dispute the decision. The designated winners would claim the support to be inadequate. Those industries undesignated would clamour for inclusion on the winning list. Cash would be flowing out; many marginal voters would be angry or disappointed. The electorate generally would see no tangible return in the form of, say,

higher average real disposable incomes or a lower unemployment rate within the magic four or even eight years. They would see, instead, taxes or borrowing rise or cutbacks in other programs.

In the time horizon of ministers any program that does not provide a perceived net benefit within four years is a non-starter. Twelve years probably would lapse before tangible net benefits (if any!) would start to emerge from an industrial strategy. Yet it would entail the immediate generation of political and financial costs. To put it facetiously, such a strategy would seem to be a triple non-starter.

Even if by chance such a strategy were adopted and succeeded, the net benefits probably would be so diffused and the precise contribution of the policy so uncertain because of the welter of other short- and long-run economic changes (some of foreign origin) over the period that it would be difficult to convince the electorate that political credit should be given where it was due - to the government that instituted the policy in the first instance. If a relatively small group were perceived to have captured all or most of the benefits, a different kind of political problem would emerge.

It would seem to be true that most of the foregoing problems would result even if a government were to back away from the adoption of an overall industrial strategy and decided to approach the problems industry by industry. Heavy costs at the outset, both political and financial, and distant but uncertain and diffused payoffs, are necessarily involved in any long-term industry strategy, virtually by definition. There is therefore a fundamental and enormously important incentive for ministers to adopt short-term 'solutions' to long-term problems on a temporary basis even when they know full well that one short-term solution will have to be followed by another and another, with the result that substantially greater long-run <u>economic</u> costs are entailed. In this important instance, however, the political arithmetic of ministers is the inverse of the cost arithmetic of the economist.

<u>The issue of compensation</u>[5]

A government decision to close down, phase out, or scale down one or

5 I am greatly indebted to a draft paper written by John Quin and

more industries immediately raises the issue of compensation for the losers. Unless the losers are compensated, how can we be sure that an industrial strategy would improve the economic welfare of Canadians? That is the normative question. The practical question is simply put: without compensation can ministers adopt, or fail to adopt, domestic policies that would result in the phasing out or scaling down of one or more industries, however sensible such a decision might be in economic terms?

The concept of Pareto optimality is a decision rule or precept widely accepted by economists: adopt policies that would result in gross gains in the output of the goods and services wanted by individuals that would be sufficiently large to compensate the losers (if any) with something left over that could be used to make one or more persons better off. Although seemingly commonsensical, that more 'good things' on a net basis are better than less, it hides an important ethical rule or behavioural assumption. Because it refers to aggregate output and does not consider who would enjoy the net gain, the precept either involves the ethical rule that those who are unfortunate enough not to share in that gain should not suffer a loss of personal satisfaction through jealousy, envy, or resentment or it assumes that in fact that they do not. The ethical rule sounds laudable enough; the implicit assumption about reality, however, is surely false. Jealousy and envy are strong and pervasive emotions. Granted that such feelings exist, unless one is prepared to assume that the extra satisfaction of those who partake of the net gain exceeds the loss in satisfaction of those who do not, it is impossible to say categorically that more output is better than less.

I belabour this point because the concept of Pareto optimality is the central definition of economic efficiency in modern welfare economics. From the outset (it was incorporated into the body of theory in the 1930s) its validity was recognized to hinge on the assumption that the satisfaction of each individual was independent of the satisfaction of others. By this seemingly simple but, as I have argued above, most implausible assumption, economists were able to separate completely the question of economic efficiency from the question of the distribution of income and wealth. Because the beliefs or preferences of economists on distributive questions

---

Michael J. Trebilcock, 'The role of compensation in regulatory reform,' prepared for the Economic Council Canada, April 1980.

are worth no more than those of others, if a 'legitimate' goverment decides to redistribute income and wealth the economists' injunction is both clear and commonsensical: redistribute income/wealth as you see fit but proceed in such a way as to incur the least possible economic cost (output forgone).[6]

Unfortunately the redistribution question is not as simple as this injunction would suggest. Virtually every change in goverment policy has both efficiency (aggregate output) and distributive effects, whether intended or unintended, whether proclaimed as the objective of the policy change or not mentioned or even denied.

Let us leave aside policies that have as their stated purpose the redistribution of income and wealth, where the foregoing injunction presumably would apply. To satisfy the Pareto-optimal criterion, each prospective policy change not deemed to be redistributive intentionally would have to be analysed to determine the following:

- Would there be a net gain?
- What would be the total amount of compensation that would have to be paid?
- Would it be feasible to identify the individual losers and the amounts of their losses in order to compensate them?[7]

Even if one were to make the heroic assumption that the first questions could be answered with reasonable reliability, in most instances it would be discovered that the answer to the last of the three questions would be in the negative. Either actual compensation would be utterly impossible or the transactions (information/barganing) costs would offset or more than offset all but the largest net gains from the policy.

The concept of Pareto optimality has many attractions for economists who wish to make normative statements in complete isolation from the political process, a process in which property rights held by individuals are, in effect, being added to (capital gains) and subtracted from (capital

6 As mentioned in the introduction, economists on the extreme right believe that any such costs are too high, usually without reference to reliable evidence.

7 Although there was some debate about the issue on the past, the Pareto criterion is not met unless full compensation is actually made. The

losses) every day by a ceaseless torrent of decisions great and small. Given the incentives under which politicians, bureaucrats, journalists, and interest group leaders function, there is no reason to believe that any of them would find this particular decision rule even interesting, much less compelling. Why would the winners not resist the subsequent compensation of the losers? Why would the potential losers not resist the proposed policy change that would impose the loss in the first instance? Is it not also true that one's enthusiasm or distaste for the proposed policy change would likely be greatly affected by one's attitude towards the probable beneficiaries? Do people really wish to see their enemies rewarded and themselves denied?

Buchanan and Tullock in their book Calculus and Consent make the valid point that majority rule is only one of many possible decision rules. It permits, and indeed may encourage, the coercion of minorities by the majority. The implication is clear: ideally, collective decisions should be determined by a unanimity decision rule. Under such a decision rule the potential losers would not agree until they had received satisfactory guarantees of compensation. Adoption of a unanimity rule would, in an ideal world, constitutionalize adequate compensation. In recognition of the practical problems involved, the authors advocate the adoption of, say, an 80 per cent affirmative rule. For those who, like Buchanan and Tullock, strongly prefer minimum government intervention, their prescription has a great deal of appeal at the highest level of abstraction. Ignoring a whole host of insurmountable practical barriers, the simple fact is that the 80 per cent rule is not embodied in the constitution of any major democratic country. One would have to be extraordinarily romantic to expect that it will ever be widely implemented in large democratic collectivities. Would those who are winning under a majority rule vote in favour of a rule that would increase the power of minorities?

More recently, Tullock has argued that governments should provide full compensation for policy changes in order to reduce the barriers to 'reform'.[8] For Tullock reform means the withdrawal of government intervention, which impedes markets and reduces overall economic efficiency.

---

potential for compensation is not acceptable because it assumes that one can compare the additional satisfaction of a winner with the reduction in satisfaction of a loser. Clearly this must be an entirely subjective comparison.

8 Gordon, Tullock, 'Achieving de-regulation - a public choice perspective,' Regulation, Nov.-Dec. 1978, p.50

Presumably this would encompass measures that have as their stated purpose the redistribution of income and wealth. There seems little doubt that the failure to compensate does make it inordinately difficult for ministers to carry out the kinds of reforms Tullock and those who share his beliefs espouse. The source of the problem is not hard to find. Tullock and company are, in essence, asking politicians to withdraw the concessions (favours) they granted in the past in their struggle for re-election. A few vital points do not seem to have occurred to Tullock, however. Consider two obvious policy areas that are riddled with special advantages (e.g. highway transport licences in the case of the former and depletion allowances for the extractive industries in the case of the latter). Full compensation of the losers under regulatory or tax reform would amount, in effect, to capitalizing the advantaged and providing them with a lump sum payment in lieu of the forgone stream of income. Would the marginal voters who were opposed to these concessions in the first instance now be willing to acquiesce in being taxed to pay compensation when they resent the benefits they have provided to the advantaged in the past? The only compensation politicians could provide to the compensators would be that national output would increase by an uncertain amount and they would have an uncertain share of the additional output. If the advantaged groups were powerful enough to secure past advantages what would keep them from garnering the lion's share of any future additional output? Why would ministers put their foot on this suicidal path?

Tullock argues that nations cannot afford to adopt policies that entail social costs that exceed social benefits. This is highly questionable. Wealthy nations can 'afford' vast amounts of inefficiency and waste both collectively and individually. The evidence is around us. When all wealthy nations do roughly the same thing, albeit in different ways, there is no basis for comparision. Ultimately, perhaps, a price is paid. Well-endowed, seemingly poor nations (e.g. the Republic of China) can 'catch up' by dint of authoritarian governments and enforced efficiency, at least of a kind. Nations, empires, and civilizations are toppled. Recall, however, the three- to four-year time horizon of majority governments. Contrast that with the long pull that would be required to raise the economic and military power of the Republic of China to levels capable of toppling either the United States or the Soviet Union.

The Pareto decision rule and the proposed Buchanan-Tullock decision

rule, together with more recent work by Tullock, are directed exclusively towards compensation attendant upon changes in domestic government policy. Neither considers the demand for compensation for losses sustained as a result of policy changes made by foreign governments or as a consequence of 'acts of God.' Canadian oil price policy and the existence of government compensation to communities hit by natural disasters both suggest that potential or actual losses, whatever their origin, are immediately followed by demands upon government to 'do something.' This raises the question of private sector insurance. What role can it play in compensation?

Insurance

Our lives are affected by an infinite number of random shocks. Some of them have a known or knowable probability distribution. Although the world is not certain, it is possible to estimate the likelihood of some events with considerable certainty. Under these circumstances insurance markets can arise because it can be profitable to pool risks: the insurer assumes a multitude of (relatively small) risks and obtains the spread between the sum of the premiums and the sum of the claims. In this way uncertainty is converted for a price into certainty for the policy-holder. The prudent (i.e. fit) are left whole, assuming that they have had the wherewithall to pay the premiums.

The limitation is that markets in risk are most imperfect. Insurance falters when the cost to the potential insurer of obtaining the information on which to ascertain the risk is high relative to the potential liability or where the potential liability is so great ('acts of God') that the transaction costs involved in pooling a given risk among many insurers are prohibitive.

The economic consequences to an individual of unemployment or inflation are, for example, uninsurable. So are the consequences of a volcanic eruption. It is not primarily because the probability of the event is too difficult to asssess (Lloyd's insurers will place bets on Betty Grable's legs for a price) but because the amount of the potential loss is of such enormous size with respect to unemployment or inflation or volcanic eruptions relative to the wealth of the private insurers among whom the risk could be spread. The number of insurers among whom a potential

risk can be pooled is limited by the information and negotiating costs involved in deciding on the premium and ascertaining the share of the risk that each will assume.

Furthermore, and of particular importance to our topic, even when insurance is available, as the premium rises the individual or group at risk finds it increasingly attractive to invest in (lobby for) a change in legislation that would preclude the adverse event or compensate him if it were to occur. The circumstances under which this investment in the political market, as distinct from the economic market, can occur have already been alluded to. Needless to say, anticipated rates of return are highly relevant to the decision, and so is the free rider problem in organizing the individuals at risk.

The federal government has a number of general compensation schemes that are called insurance: unemployment insurance and group insurance come to mind. These are not, of course, insurance programs in any actuarial sense, but that is irrelevent here. The point is that they do provide compensation for short-term losses as a matter of right and on a largely routine administrative basis. The same kinds of programs almost certainly could not be developed for losses sustained as a result of the government's decision to phase out or close down a particular industry because of adverse long-term international changes. Certainly circumstances would alter cases, and circumstances would differ greatly from industry to industry, from firm to firm, and from time to time. General conditions of entitlement would be impossible to define, as would a benefit structure.

Logrolling

Logrolling is commonplace in all political systems (see Albert Breton, A Theory of Representative Government). The immediate actors in a parliamentary system are ministers who obtain the support of some of their colleagues for a proposal in exchange for the promise of future support for some, often unspecified, future proposal(s). The ministers are for the most part only proxies for the interests they represent. The result is that, in effect, an endless series of exchanges take place between the interest groups they represent. What a group may lose in a policy proposal their spokesman supported they may gain, more or less, on a sub-

sequent proposal their spokesman pushes through with the help of those he has or is helping. Because logrolling involves a kind of sequential voluntary exchange, it provides a degree of compensation to losers.

Although logrolling is ubiquitous and does provide a measure of compensation, it is impossible to ascertain the degree to which it fully compensates losers. Cabinet meetings are secret, the contracts are usually unspoken, the denominations of the IOUs vary with the issue involved and credibility and authority of the debtor. The intervals between when the debt was incurred and when it was called can vary enormously. Of particular importance is the fact that all interest groups are not represented equally in this logrolling process. Just as those individuals who do not attend meetings are likely to find that the members present have unanimously agreed to assign them unpleasant chores, so under-represented interests are likely to find themselves saddled with uncompensated costs.

Bureaucratic infighting

Just as the interests of ministers are not necessarily (and usually are not) congruent with maximizing long-term national income, so the interests of bureaucrats are not necessarily (but usually are) congruent with maximizing the interests of ministers. Just as cabinet decision-making involves a complex mixture of the collegial and adversarial modes, so does bureaucratic decision-making. Just as ministers fight for the departmental interests they represent, so do the senior officials of their departments. Just as ministers constrain their conflicts in order to maintain the government in office, so do senior officials constrain their conflicts in order to maintain the bureaucratic system. As explained in the previous section, the fundamental motives are the same: the political career aspirations of ministers are endangered if not destroyed when their government falls. Similarily, the career aspirations of bureaucrats are endangered and some times destroyed when intra- and interdepartmental reorganizations take place and/or centralization-decentralization cycles occur and/or the prime responsibility for a new policy is assigned elsewhere in the bureaucracy.

The development and implementation of a new industrial strategy along the lines previously mentioned would cause enormous bureaucratic ferment. The thought of the empires to be built would bring a glint to the eyes of some. The thought of empires to be lost would harden the defiant stares

of others. Virtually every department and agency would be affected, although obviously some more than others. No senior official could be excluded from the steering committee. The battle for the lead role among several obvious contenders, given the enormous implications of such a policy change, perhaps would be brief, but it certainly would be not bloodless. Many committees would be struck, and subcommittees for each committee, and working parties for each subcommittee. Meetings, studies, assignments, memoranda, consulting contracts, and advisory groups would proliferate. The common subject matter would be the development of an industrial strategy. The common game would be the competition for jurisdiction and influence.

All this would be enormously time-consuming and would inevitably involve much inter-agency negotiation, shifting alliances, and slowly reached compromises. Although frustrating for ministers in some respects, some part of the bargaining would be on behalf of the individual ministers to whom particular bureaucrats report.

The foregoing description of the bureaucratic decision-making system is something of a caricature. It understates the role of ministers; it understates the extent to which some of the best bureaucrats downplay their self-interest when dealing with a major policy issue; it understates the fact that because the time horizons of officials are much longer than those of ministers - for most officials the public service is a working life attachment - they tend to lean against the short-term facile solutions so dear to ministers. In that dimension at least they are, in a sense, more representative of the interests of the electorate than are ministers. Nevertheless, it would be unwise to dismiss the role of bureaucrats as a constraint in developing an industrial strategy.

Securing provincial agreement

Particularly with majority government the real opposition the government faces comes in many respects from the provincial premiers. They are most unlikely to acquiesce in an industrial strategy that did not provide each of them with a least a prorated share of the potential net benefits. And these net benefits would have to be distributed within each province in such a way as to be conducive to the re-election of the provincial governing party. Even if this could be achieved by an industrial strategy, it is

most unlikely that it would be acceptable to many and perhaps most premiers. Some would insist that old wrongs be righted (e.g. the Atlantic provinces). Others would use their currently greatly enhanced bargaining power to press for a disproportionate share of the potential net benefits (e.g. Alberta). Others, such as Ontario and B.C., would threaten to hurt the federal government at the polls if traditional provincial advantages were not maintained. As Ontario's sandbagging of the Pickering airport demonstrated, and as Alberta's threat to cut off crude oil supplies to the Sarnia petrochemical complex portend, the present constitution does not prevent the provinces from frustrating federal initiatives.

With further and further decentralization of power to the provinces a virtual certainty - if not a breakup of Canada - securing provincial agreement on a common national industrial strategy would be a task of mind-boggling complexity. Think of the time that would be involved. Think of the rancour that would be generated. Think of the concessions that would have to be made. Now think of the disparity between the dream of a federal government statement that a coherent, consistent long-term rational industrial strategy were to be implemented immediately and what is likely to emerge eventually, if ever, given the foregoing difficulties.

THE POLITICAL BARRIERS TO THE ADOPTION OF AN INDUSTRIAL STRATEGY

This section, the heart of the paper, seeks to explain why the explicit and implicit incentives involved in the existing Canadian political system, as sketched in the first section, together with some particular constraints described in the second section, create major barriers to the adoption of an explicit industrial strategy geared primarily to international economic changes as defined in the introduction. Underlying that strategy was the assumption that it would be possible to identify, at least on a probabilistic basis, the potential impact of significant international economic (including technological) changes on existing and/or potential Canadian industries. It was also assumed that it would be possible, again on a probabilistic basis, to differentiate between short-term and long-term changes and, for the latter, between those likely to have an unfavourable impact and those likely to have a favourable impact, at least if opportunities were exploited. Finally, it was assumed that differentiated subsets of policies (strategies)

could be developed and implemented for the industries, extant or potential, that probably would be significantly affected by each of the three types of international changes. Crudely put, the three strategies would seek to accomplish each of the following:

- Short-term changes: 'lean against the wind' by providing, where necessary, temporary support for industries in temporary difficulty and by impeding inordinately large responses to favourable changes of a temporary nature.
- Long-term negative impact changes: induce industry closedowns, phase outs, or phase downs.
- Long-term positive impact changes: induce, through assistance in one form or another that would be phased in <u>and then phased out</u>, the expansion of existing industries or the creation of new industries to take advantage of opportunities unlikely to be exploited fully in the absence of the assistance for one reason or another.

It will be recalled that the major readjustment of an industry that involves a change in the type of output should for our purpose be thought of as a simultaneous application of the second and third strategies to an existing industry.

Many Canadian industries are little affected, except most indirectly, by international economic developments (e.g. the service industries). Such industries would <u>not</u> fall within the purview of the industrial strategy, which is not to deny the need to make improvements in the overall tax, expenditure, and regulatory systems of general applicability.

Some of the assumptions are not readily accepted. How feasible would it be to differentiate between short- and long-run international developments on a reasonably reliable basis? There is, it would seem, no general answer to this basic question: clearly it depends on the kind of change. Analyses would have to be carried out on a continuing basis on a whole range of international changes such as exchange rates, relative factor or product prices, productivity, and technology and the forces underlying them. John Helliwell, in his paper 'Can Canada be insulated from events abroad?' has done an estimable job of analysing two such changes, U.S. interest rates and energy prices, and he emphasizes the short-run/ long-run distinction. What is implied by my first assumption is that similar,

high-quality analyses could be carried out over a wide range of types of changes on a continuing basis. Admittedly, the anayses of international technological changes would no doubt necessarily be more speculative and the degree of reliability correspondingly less.

Generally speaking, the policy problem does not arise because governments do not 'lean against the wind' in response to short-term developments. Political incentives induce governments to provide short-term assistance, and the cumbersome nature of the decision-making process tends to militate against overreacting to temporary changes. The fundamental problem, as explained later, is that the incentives built into the decision-making structure greatly impede, if they do not completely block, the implementation of the 'close down-phase out-phase down' strategy when long-term negative impact changes occur. For the most part the difficulty does not arise because the nature and/or source of the change goes unrecognized. The fundamental difficulty, as emphasized before and as will be discussed later, is that a government cannot afford the political price of the economically least costly response.

There are a host of examples of government attempts to block downward adjustments. The most recent, and most dramatic, are the loan guarantees recently provided to the Chrysler Corporation by the U.S. ($1.5 billion) and the Canadian ($200 million) governments. There is also the Enterprise Development Program, a delightfully ironic misnomer, established by Industry, Trade and Commerce in March 1977. This Program is the successor to the host of earlier programs such as PAIT, GAP, and Automatic Adjustment Assistance. It provides loan guarantees and cash grants to firms with 'significant burden' adjustment problems that do not have the means to bear them. There are, on average, approximately 200 to 300 applications for firms each year of which about 50 per cent are approved in whole or in part. Roughly $200 to $250 million in loan guarantees are authorized and cash grants of about $50 million per year are made, supposedly aimed at financing innovation. Special subprograms have been devised for such depressed industries as textiles and footwear. The grants for innovation perhaps contribute to some industry or firm adoption. For the most part, however, the loan guarantees are little more than handouts that keep firms that are in distress, largely as a result of international developments (e.g. GATT or the Auto Pact), from bankruptcy without inducing adaptation.

The impediments to carrying out successfully the strategies that would be entailed in exploiting industrial opportunities arising from potentially favourable long-term international developments are quite different. Putting to one side the purely political problems, these include the following:

- substantially greater risk,
- the problems of devising assistance schemes that do not create perverse incentives for those actually engaged in the favoured industry(ies),
- providing major windfall gains to the new breed of private enterpreneur able to capitalize the government assistance and run.
- These substantial hurdles are discussed below.

Perhaps the most dramatic current example of government entrepreneurship is the long-term but now rapidly accelerating federal-provincial conflict over the development of coal deposits located in north-eastern British Columbia. Their development hinges crucially upon the provision of rail transportation facilities to Prince Rupert. Timing is of the essence; premature development could depress the price of the coal now being explorted to Japan from southern B.C. deposits. Delayed development might foreclose an opportunity to expand exports to Japan, a nation that is becoming increasingly concerned about its heavy reliance on Australian coal.

In the military equipment field disasters abound: the ill-fated Arrow fighter aircraft, the Bras D'Or hydrofoil submarine chaser, and the personnel carrier immediately come to mind. All three were designed and developed primarily with an eye to foreign sales. All three were abandoned after major expenditures had been made. In the civilian field the Bricklin automobile venture and the Come-By-Chance refinery will be long remembered in New Brunswick and Newfoundland.

A long (and perhaps longer) list of disastrous government-supported ventures (at least by normal private sector standards) that have not yet been abandoned where, to use the old phrase, 'good money is being thrown after bad,' could no doubt be compiled. Minaki Lodge comes to mind.

To be fair, however, there have been some success stories. The Canadian Pacific Railway was, in nation-building terms, a triumph. In

more recent times, at least, some of the loan guarantees provided by the Export Development Corporation and the Industrial Development Bank were successful, as were some of the investments made by Petro-Canada. An overall assessment of the performance of these government organizations is not available to the best of my knowledge (which is most imperfect).

This paper does not advocate an industrial strategy with the basic characteristics of the one that has been outlined. Rather, its purpose is to explain why governments are unlikely to adopt a comprehensive industrial strategy that in my view probably would be superior to what they are doing now. What governments are doing now is adopting two non-strategies: first, makeshift, short-term 'solutions' are being applied to long-term international developments that have negative implications for Canadians, with the result that the problems are usually perpetuated and often intensified; secondly, no consistent, co-ordinated attempt is made to capitalize upon the changing comparative advantages Canada possesses in the light of long-term changes in relative prices and technologies.

Many members of the business and academic economic communities would argue that if only governments would back off entirely and let markets work we would simply be able to observe which were the losing and winning industries. Moreover, they would argue that national output would be greater in ten to fifteen years under such a regime than it would be with some conscious government strategy of choosing winners and losers and adopting differential forms of government intervention for each. I have no particular quarrel with this line of argument. If maximizing GNP over time were the sole goal and if governments would extricate themselves from all forms of market intervention, their prognosis is probably correct, assuming there were no revolution in the literal sense of the word. As stated earlier, however, political markets are dominated by the pursuit of maximization of the likelihood of re-election or election not economic output maximization. In addition, I strongly believe that no political party that advocated, much less implemented, a laissez-faire approach to the economy with the consequent income/wealth distribution could be elected, much less re-elected. In my opinion neoconservatism makes for great rhetoric and elegant theory, but it will ultimately have only a marginal and temporary impact on policies.

To put the matter slightly differently, if the neoconservatives think an explicit industrial strategy along the lines indicated is a bad second-

best solution, what I am saying is what we have now is almost certainly a bad third best. Not only is their best hopelessly unattainable in my view (it is my personal belief that the income/wealth distribution consequences would be undesirable). I would forecast that without some fundamental changes in the structure of the political market we will continue with the status quo or worse.

In the balance of this section I consider in turn the potential barriers to the adoption of the two hypothetical long-term substrategies. As indicated above, the short-term strategy poses fewer problems and is largely ignored here.

Although the discussion is cast largely for expository convenience in terms of a comprehensive strategy for all industries substantially affected by international economic developments, most of the following points would apply to particular industries, as mentioned in the introduction. Recall too that the term 'industry' is a shorthand way of describing groups of marginal and intramarginal firms producing roughly similar outputs.

Alternative strategic responses to long-term international developments with negative implications for Canadian industry

This subsection considers the strategies that might be adopted by government to close down, phase out, or phase down one or more Canadian industries that, because of one or more adverse long-term international developments, have virtually no chance of long-term survival without ever-higher protection or financial assistance.

Of this infinite number of conceivable strategies only three are considered here: the two polar cases that involve, at the one extreme, the government doing absolutely nothing and thereby letting them 'die on the vine' and, at the other extreme, the government providing full, direct and immediate conpensation. The third case involves the intermediate alternative of providing indirect and delayed compensation.

The non-intervention strategy

This is the 'let the markets work' approach that is one side of the coin of the classical economic model. Those entrepreneurs who do not have the wit (or the luck!) to anticipate adverse changes and adapt to them simply go bankrupt. The workers are forced to search for alternative jobs. This

may require them to accept a lower wage and/or move to another community. But because it is assumed that the factors of production have alternative uses, sooner or later the output of the declining industry(ies) shrinks and the output of other industries increases. Aggregate economic welfare may have increased or decreased as a result of the adjustment. What is certain is that it would have increased less or decreased more had the adjustment not taken place.

Consider one simplified example: suppose that Canada has a textile industry that came into being without a tariff or other government support. Suppose that imports begin to displace domestically produced textiles. Despite the existence of a flexible exchange rate, depreciation of the Canadian dollar does not take place because in relative terms the industry is small. The least efficient firms go out of business first. The displaced workers seek and eventually find jobs in a relatively small export-producing industry. The increased supply of labour available to that industry tends to lower wages in it compared to what they otherwise would have been. Consequently, it becomes more competitive internationally and its foreign sales increase compared to what they otherwise would have been. The Canadian consumers are better off because textiles are cheaper. The shareholders in the textile firms are worse off of course. The textile workers are worse off too because they had to endure some temporary unemployment and/or relocation costs. The wages may be somewhat lower, depending among other things on skill requirements. The workers in the export industry are worse off because the increased competition in the labour market holds their wages down, at least compared to what they otherwise would have been.

Had the government intervened, say by first introducing and then gradually raising a tariff on textiles, Canadian consumers would be worse off because textile prices would rise. Assuming demand is sensitive to price, domestic textile output would decline but by a lesser amount than had the tariff not been increased. Moreover, consumers value less highly the other goods they buy because of higher textile prices. Fewer textile firms would close down, fewer textile workers would be unemployed, etc. In all likelihood the value of aggregate domestic output would be reduced with the tariff and without adjustment relative to what it otherwise might have been. However, the distribution of income and wealth would be different. The consumer generally would be denied again: textile in-

dustry shareholders and workers would sustain a smaller loss. In principle, consumers generally would have been better off to have compensated the shareholders and workers in lieu of the tariff increase. However, under the strategy being discussed neither a tariff would be introduced nor compensation paid. It should be noted that the Pareto optimality criterion only addresses the issues of compensation for losses incurred as a result of changes in domestic policy (e.g. eliminating an existing tariff). That would increase total output. Losses sustained as a result of international changes are outside its ambit.

Let us consider now the circumstances under which the government of today is likely to reject the demand for tariff protection, or some other form of government assistance, and not provide any compensation to the losers.

Clearly voters/consumers/taxpayers do not want to pay higher prices for textiles, nor do they wish to be taxed to finance compensation. Moreover, they are much more numerous than textile shareholders or workers. Superficially it would seem that to maximize the likelihood of their re-election the ministers should reject demands from the textile industry for either tariff protection or other assistance, because many more voters would lose more in aggregate as a result of intervention than would gain through intervention. The political model sketched in the first section suggests, however, it would be a politically foolish course of action under some circumstances. The basic conditions listed below, among others, would make intervention politically expedient.

- Those who would lose by the decline in the textile industry (primarily shareholders and workers, but also those significantly dependent upon them directly or indirectly) were and would remain intramarginal voters. That is to say, they were voters who were irrevocably committed to one party or who always abstained from voting or who are resident in ridings where one party invariably has a plurality of votes because of the support of intramarginal voters.
- It is difficult to believe that the losers would remain committed supporters of the party in office if they were to think that shifting their allegiance could affect the outcome. Indeed, one might suppose they would vote for an opposition party to protest if nothing else. Realistically, ministers could only ignore the almost certain loss of support of those

voters with major textile industry interests (assuming there had been such support in the past) if these disenchanted voters were concentrated in ridings that could not be won in any event. Conceivably, but also quite hypothetically, this could occur if a Conservative government were in office and the textile industry were concentrated in the eastern townships of Quebec, ridings that invariably were won by the Liberal Party.

- Even if the inverse of the foregoing condition obtained and some ridings were likely to be lost by denying assistance, it would make sense to deny assistance if a significant number of consumers of textiles (that is to say voters generally) who were marginal voters voted for the opposition party if they were denied the benefits of lower textile prices or because of the tax increase required for compensation. Although such a consequence is not out of the question, one would have thought that the proportion of marginal voters whose decisions at the polls would be affected by the relatively trivial additional costs per consumer would be insignificant.
- The textile interests were unable to organize and raise financial and people resources with which to offer quid pro quos to those involved in the decision or to develop publicity campaigns designed to generate support, via the media, for assisting the poor workers and, probably, their threatened homes and communities. This clearly is an improbable scenario. The potential benefit to be had from averting the loss through achieving government support would be large. Shareholders, managers, and workers (particularly if organized) could not afford not to contribute. For a small, organized industry the free rider problem would not be severe.
- Conversely, consumers could organize and finance a campaign of opposition to government intervention sufficiently strong and persistent to overwhelm the industry group. Again, this would be a most unlikely scenario because the free rider problem would be enormously difficult in these circumstances. A continuing consumer group such as the Consumers' Association of Canada could devote only the smallest fraction of its small budget to this single issue.
- There would be ministerial and bureaucratic pressure for intervention (e.g. the minister of industry, trade and commerce). The minister would not only be pressing one of his responsibilities, 'encouraging' secondary manufacturing, he would also seek to appear to be a powerful friend at court of the business community generally. - If the industry were geographically concentrated, the government of the province in which it was

located was either indifferent to the plight of one or more of the communities in its jurisdiction and/or powerless to exert pressure on the federal government.

No doubt other conditions could be included, but this list shows that a rare set of circumstances would have to prevail to make it inexpedient for ministers to take a hands-off strategy to an industry faced with a long-term decline.

<u>Direct and immediate compensation</u>

Under this alternative the government would make, in effect, a lump sum payment for those adversely effected by the immediate and final shutdown of at least some firms in the industry(ies) adversely affected by long-term economic development. Optimally, from a political point-of-view, only marginal voters would be compensated, and the costs would be imposed on intramarginal voters and/or spread widely and thinly among virtually all voters. Even if, as is likely, compensation were provided more broadly on equity grounds, if the present value of the compensation were less than the present value of the cost of keeping the irrevocably holed boats from sinking, at least in principle the nation would be better off.

This kind of draconian resolution could certainly be quickly announced. However, several extraordinary difficulties must be recognized. First, those adversely affected are most unlikely to accept readily the opinion of 'experts' that their industry or firm is beyond salvation. Secondly, the task of arriving at some acceptable compensation formula would be, to say the least, a painful exercise unless it were outrageously generous. What compensation would be appropriate for a younger worker with no industry-specific training and skills compared to that for a worker with such skills, twenty-five years' seniority and ten years from retirement? If workers were compensated could shareholders be denied? If the community were heavily dependent upon the industry or firm(s) should everyone who had a stake in the community have a claim to compensation? Should the availability of alternative employment be taken into account? If so, over what time period? A third difficulty from the point of view of the government of the day is that, virtually by definition, the announced decision to terminate a group of marginal firms in an industry would lead to the creation of one or more narrow special interest groups or would revitalize such groups if they already existed. As discussed immediately

above, employees, shareholders, and suppliers could hardly afford not to organize in pressing for either a reversal of the decision or more generous compensation. If the industry were concentrated geographically and/or the workers were represented by a strong union the greater would be the pressure, including provincial government pressure.

Finally, and perhaps surprisingly, I think it would be discovered that worker compensation paid on a weekly or monthly basis that was roughly equivalent to the wage forgone (like early retirement pensions if you will) would not be treated as adequate by many of the workers affected. There are more benefits derived from a job than the wage. An examination of the experience in trying to phase out Cape Breton's Devco coal operation in the 1960s would attest to that proposition. Weekly or monthly compensation contingent on not working would of course have extremely perverse disconcentration effects for workers.

Indirect and delayed compensation

This strategy would involve a peculiar kind of substitution: the government would announce its invitation to phase down or out one or more declining industries by withdrawing or withholding, while it would simultaneously phase in one or more of high growth potential by providing substantial government support in the expectation that it would not only become self-sustaining but would 'take off' both domestically and internationally within, say, five to ten years, providing an ever increasing number of well-paid jobs, eventually profits for investors, and perhaps even lower prices for consumers.

It would be delightful if the declining industries that were to be phased down or out would supply the same labour and managerial skills both in quantity and quality required by the high potential industries being phased in. It would be even more delightful if the latter located in roughly the same communities at no extra cost.

As discussed above, ministers and parties quite consciously take into account the rational ignorance of voters in their attempt to resolve conflicting interests and thereby achieve electoral success. No cabinet that had not taken leave of its senses would count on such fortuitous matchings of losers and winners. Ministers would immediately grasp the obvious point: why would any individual or group that would be disadvantaged by the phasing out or down of an industry or firm voluntarily accept that

certain loss for the uncertain compensation of a possible job in an industry that might have a growing future? A guarantee that the phasing out would be geared to employee attrition would be some solace no doubt. But even this guarantee would not console a community largely dependent upon one industry or firm. And Canada has many such communities. One might speculate that many, and perhaps most, of the industries and firms on the X list dominate the communities in which they are located. When they are resource-based (e.g. pulp and paper, furniture, petrochemicals in Sarnia) this is true by definition. The negative implications for property values, service type businesses, employment opportunities for children, and so on are painfully obvious.

Tying the phasing-down or out of an industry(ies) to employee attrition in the declining industries would be only one of many kinds of indirect compensation that could be provided. Here is a partial list of additional indirect compensation measures: retraining grants, mobility grants, compensation for losers related to real property or business, income losses, community relocation programs (Newfoundland), job placement services, DREE-type grants to firms willing to locate in the depressed area and subsidized infrastructure for the area. All these programs, and more no doubt, are in place now.[9] Is there any doubt, however, that all of them, even if enriched and embellished, would be rejected as inadequate compensation by those who would be adversely affected by the announced government decision to gradually withdraw or deny assistance to one or more declining industries. The reasons are straightforward:

- The government's decision to phase out or down would convert a risk of a loss into the certainty of a loss. The compensation would be uncertain as to timing or amount, hardly an attractive proposition.
- The losers might privately agree with the analyses (analyses that most of those adversely affected would ill understand at best) that con-

9 In some ways the various programs of the federal Department of Regional Economic Expansion have attempted to make miraculous substitutions a common occurrence. Putting to one side the decision of ministers to designate some areas as depressed solely for political advantage, depressed regions are those dominated by one or more industries that have declined or are declining. After all, a region would have virtually no population if there had not been a reasonable living to be made there at one time. DREE has subsidized transportation, power, and other networks for these regions under General De-

cluded the chances were small that their industry(ies) could survive without continuing and probably increasing government assistance, but would they not marshal the professional resources requisite to dispute the findings?

- Would the competing political parties not immediately promise to 'save' the industry or firm and, where applicable, the community? Politicians are not elected by admitting they can do nothing. For, in point of fact, they can always do something, albeit something hopelessly uneconomic that may in the longer term exacerbate the problem. The nation may be worse off, but not the voters whose interests have been protected.
- The electorate discounts promises. Yet there is not likely to be much tangible evidence of either phasing in or phasing out within the three- to four-year ministerial time horizon. Indeed, it would be rather miraculous if the ministerial bureaucratic and federal-provincial negotiations were completed, the legislation enacted, and the requisite studies carried out in that time. Even if the list of designated industries were not released prior to the election, the quasi-open federal-provincial negotiations probably would have raised more fears than hopes in the minds of voters.

It is impossible to provide any estimate of the net potential cost to a government of adopting an indirect and delayed compensation package of the kind just described relative to the two polar cases discussed in the previous subsection. It would depend obviously on the particular industries, marginal firms, their location, the burden on the public purse, the electoral map, and the distribution of marginal voters and ridings, to speak only of some obvious factors. Is it not reasonable to suppose, however, that the support would be lost of all marginal voters adversely affected by the phasing out because they would be most unlikely to accept the phasing in as adequate compensation and certainly less attractive than

---

velopment Agreements. It has also made capital grants to employers: tens of thousands of dollars per new permanent job created that supposedly would not have been created without the grant. Decisions to grant funds are based on feasibility studies. I recognize that DREE perforce settles for shifting firm location and for potential survivors. This is hardly the same as supporting potential winners in the sense that the term is used here.

the promises of competing parties to support the flagging industry or enterprise. This group might well attract committed supporters of the governing party too. As explained above, a well-organized pressure group with ample financial resources and volunteer time could spread the message far beyond those immediately affected and influence decisions throughout the industry and the bureaucracy and gain media support. Such a pressure group could also use the panoply of tactics of polite blackmail and bribery to which reference was made earlier. One should reflect for a moment on the durability of the pressure group of individuals who maintain their residences on Toronto Island despite their lack of title.

The next subsection considers the political costs and benefits of designating all their support of existing or new industries with enhanced long-run growth resulting from favourable international economic developments.

The political problems in designating and supporting industries with high growth potential because of favourable international developments

In discussing the indirect and delayed compensation strategy it was simply assumed that the high-growth-potential industries that conceivably should be substituted for declining industries had been designated and the appropriate non-permanent support policies of one kind or another devised. This subsection considers the problems that work behind that assumption.

Sir John A. Macdonald was reputed to have said, when asked about the exercise of his power to make Senate appointments, that each appointment created one ingrate and dozens of enemies. The same could be said of the designation of a 'winning' industry or firm. While they would no doubt be delighted at the outset, what is to prevent the advantaged from reinvesting some of the proceeds in political action designed to secure even greater advantages? There is nothing to prevent the winners from switching party allegiance in the next election if that were judged to be to their advantage.

Having committed themselves to a course of action it is virtually impossible for individual ministers or governments to admit to error. They are under enormous pressures to see it through to a 'successful' conclusion, even if in economic cost terms the program or project turns out to have been a dreadful mistake. Opposition parties, the auditor general, journalists, and millions of armchair quarterbacks are omniscient.

No minister would expect the electorate to remember, should a particular designated winner be about to fail, after the expenditure of perhaps hundreds of millions of dollars of public funds, that the industrial strategy, as originally announced, was predicated on probabilities. The implication that some bets would be lost and the losses would have to be written off would almost certainly have been downplayed or not understood. The economist's admonition that sunk costs should be ignored is sensible advice to a private investor. It is advice that a politician can rarely heed if he wishes to remain in office. This being the case there would be nothing to prevent the designated winners from resting on their oars, knowing that they would have to be made to appear to be winners without much regard for cost by the government (assuming the same party were in power).

If a policy of designating and supporting potential winners were adopted it would be important to devise, if possible, an incentive system that only rewarded those shareholders and managers of enterprises who, albeit with government assistance, converted potential winners into actual winners. It would be difficult to conceive of schemes where taxpayers generally did not take the lion's share of the downside risk and the shareholders/management did not get the lion's share of any gains. Certainly, however well-balanced a scheme was devised and implemented at the outset, there would be nothing to prevent the actual winners from lobbing ten or twenty years down the road for changes in the agreement favourable to themselves.

Certainly it would be well-nigh impossible to convince most marginal voters that they should accept an immediate and certain increase in their taxes for, let us suppose, the next ten years because thereafter the average Canadian would be significantly better off in part because of the probable increase in the tax base that probably would make it possible to lower tax rates or improve publicly provided goods and services. Surely opponents would be quick to point out that some of those engaged in the designated potential winning industries probably would be able to capitalize for their personal benefit the support the taxpayers generally would have financed and thereby obtain the larger than average share of the net gain from the 'pick-the-winner' industrial strategy.

Most of the marginal voters not directly affected by such an industrial strategy would be most unlikely to find such a policy attractive:

pay now for a trip in the distant future during which, if it takes place at all, you would not be guaranteed even average accommodation. Although unlikely to be able to organize opposition because of their large numbers and geographic dispersion, the marginal voters among them certainly would be vulnerable to the entreaties of the competing political parties.

No mention has been made of the enemies to which Sir John alluded in another context. What about the disappointed aspirants to the designated winner classification? Are there not a host of investors and executives in enterprises represented in many cases by trade and industry associations who give every appearance of believing that, with just a little more government financial assistance here, a little tax break there, and a little co-operation on those tiresome regulations elsewhere, the corporation or industry would grow like wildfire: more jobs, higher incomes, ad infinitum and ad nauseam?

But for every industry that has zero growth expectations (and these would demand phase out or phase down assistance!) there must be hundreds where buoyant expectations are mooted by those involved with varying degrees of subjective probability. Whether or not most of these expectations are realistic or unrealistic or sincerely held is largely irrelevant when it comes to forecasting their political behaviour. Associations, unions, and communities would invest in applying pressure for inclusion on the favoured list. The competing parties can hardly be expected to remain idle. Promises to extend the list would abound.

It is precisely because those interests excluded from the designated winner's list would be at first apoplectic, then energetic, and ultimately, if still excluded, sadistic that an alternative industrial strategy that only announced winners while remaining silent about the true government intention to withold support from the designated losers would make it much less appealing than it would first appear, despite its Machiavellian allure.

SUMMARY AND CONCLUSIONS

The basic argument of this paper may be briefly restated as follows:

- The paper seeks to explain why governments usually intervene to prevent the decline or extinction of industries adversely affected by long-term international economic developments even though this entails a re-

duction in the standard of living of the average Canadian. Furthermore, the measures adopted tend to perpetuate the original problem and often exacerbate it.

- For similar reasons, government usually fails to encourage the development or expansion of Canadian industries when potentially beneficial international developments occur. The failure to capitalize upon these opportunities also tends to reduce our standard of living relative to what it could be.

- This seemingly perverse behaviour can best be explained as the consequence of the pursuit of self interest by individuals, the largely implicit incentive systems under which politicians, bureaucrats, special interest groups and journalists carry out their respective functions, and the limited information available to marginal voters in marginal ridings when choosing among the alternative bundles of policies offered by the competing political parties.

- In a democracy the political decision-making process is necessarily adversarial because the interests of individuals and groups of individuals are almost invariably in conflict. Moreover, individuals and groups can, under some circumstances, best further their own interests by investing their time and money in influencing political decisions. By securing a change in the rules of the game, so to speak, or in securing favourable decisions under those rules, gains can be secured or losses avoided, if need be at the expense of others.

- In the pursuit of re-election the government party must exchange favourable decisions for the wherewithall needed to fight elections. The support of marginal voters can only be obtained by appearing to offer larger net benefits than the competing parties. This can be achieved primarily be imposing the costs on intramarginal voters whose voting behaviour is largely irrelevent, or by speading the costs so widely and hence thinly that they either are not perceived by marginal voters or are too insignificant to enable the losers to organize and bring opposing pressures to bear.

- This being the case, it would be irrational for a government to seek to maximize the standard of living of the average Canadian by pursuing the courses of action cited in the first two points above. To do so would be to invite defeat at the polls - an outcome that of course would not be in the self-interest of the politician.

- To make the pursuit of electoral success congruent with the pursuit of the economic welfare of Canadians would require basic changes in the decision-making structure that altered the incentives or constraints under which the principal actors operate.

Papers such as this one, which are long on explanations, can be short on conclusions. Readers who fundamentally disagree with the explanations offered are most unlikely to be interested in any implications that might be drawn from the framework that has been presented. Readers who are persuaded by the explanation of why the fundamental structure of the existing political system largely precludes the wealth-maximizing market adjustments to long-run international economic developments, may well be so depressed by the enormity of the task of correcting the situation that they may wish to forget the whole matter and divert themselves to more pleasant topics in order to preserve their mental health. To them all I can offer is the consoling thought that maximizing national economic welfare perhaps is not as important as they once thought it was.

By the process of elimination, therefore, these concluding comments are addressed to those Stalwarts who wish to consider the kinds of basic changes in the collective decision making structure that would ameliorate the enormous political barriers to long-term economic adjustments.

Before proceeding to provide a short list of speculative suggestions concerning the kinds of structural changes that I think would be helpful, I would like to comment briefly on the perspective from which I view the issue at hand. First, I do not believe that maximizing national wealth is or should be the dominant purpose of government or the only criterion against which policies or collective decision-making structures should be assessed. The very existence of the nation and the realization of a reasonable degree of economic justice essential to the maintenance of social stability inevitably exact a price in terms of the quantum of aggregate income and wealth forgone. Carried to its ludicrous extreme, the neoconservative position comes down to the assumption that <u>any</u> price is too high. What neoconservatives neglect to consider is that without government intervention in markets that inhibit the adjustment process the disparities in individual wealth-holding would be so great and the rationale so unacceptable that the state-enforced exclusive and transferable property

rights held by individuals, a prerequisite to the existence of markets, would be in great jeopardy. The intensity of the conflict would be greatly escalated and probably would result ultimately in resort to violence and then to authoritarianism of the right or of the left.

This is not to suggest that the price of forgone economic welfare requisite for the preservation of the nation and the amelioration of conflict is not greater than it needs to be. I am convinced that the price is unnecessarily high because the present structure is needlessly conducive to the successful manipulation of government decisions by narrow groups in their own interest. It is not simply a question of one group gaining at the expense of another. I strongly suspect that in many instances negative sum games are involved; that is to say, the winners gain less than the losers lose. In theory (and given many unrealistic assumptions), the political losers should, through government, be able to 'bribe' the losers and still be left better off. In point of fact, however, this need not occur and probably too rarely does occur. Some of reasons were set forth in the first section.

Consider the handicaps that impede the pursuit of widely held interests:

- Widely held interests are greatly disadvantaged in the adversarial process in large part because of the free rider problem. Consumer environmental and civil rights groups, to name only a few, are invariably underfinanced compared to their opponents.
- The individuals involved are too ill informed to be aware of their own interests or the effects of government decisions on their interests. In part this is because they are 'rationally ignorant' - they must ignore a large part of the torrent of 'information' that pours over them every day. Some of the information is not in the public domain or is too costly to obtain in usable form. The financial imperatives under which the mass media operate (the competition for advertising revenues) greatly constrain the range and depth of the information that the journalists employed by them can convey to their readers, listeners, and viewers.[10] The tight

10 I do not wish to suggest that advertisers often play a direct role in determining media content. Rather, I seek to address the relationship between audit circulation, Nielson ratings, etc. and advertising rates. No publisher or broadcaster will long retain the services of a journalist whose output attracts no readers, viewers, or listeners.

budgets imposed by media management and the limited attention span of those to whom they have to try to communicate, for the reason given above, makes journalists, despite their best professional efforts, vulnerable to news manipulation by the government of the day, contending political parties during compaigns, and narrow-interest-group publicity.

Less obviously, but perhaps of equal or greater importance, all the foregoing factors make it possible for governments to hide the concessions being given to special interests by resorting to extremely complex forms of benefits. For example, a large giveaway provided in the form of a 'technical' amendment to the Income Tax Act is likely to go undetected by most journalists and, if detected, often is too difficult to explain briefly, simply, and interestingly. The 'discovery' by an Albertan newspaper last summer of the inordinate generosity of the tax treatment of frontier exploration several years after the concession was introduced was a case in point.

Consider some of the advantages enjoyed by narrow interest groups in pursuit of further advantages:

- the facility with which they can organize and marshall financial and personnel resources; and with these resources they can supply favours in exchange for favours and buy professional, legal, accounting, management consulting, public relations, and lobbying assistance over protracted periods of time;
- the vulnerability of political parties and candidates given the high cost of nomination and election campaigns;
- the informational advantage they possess over politicians, bureaucrats, and journalists, not to mention voters.

The disparities in influence between widely held and narrow interests should and could be reduced in my opinion. Among the steps that come to mind those listed below perhaps convey the kind of changes that I would advocate.

- An effective Freedom of Information Act.
- Adoption of common rules governing party nominations and <u>candidate</u> election financing in order to reduce the stringency of party discipline applied to our elected representatives, particularly to members of the governing party.

- A greater role for parliamentary committees and their provision with adequate research bugets.
- An increase, somehow or other, in the funds available to public interest groups in order that they may play a more effective role in the adversary, collective decision-making process.

These kinds of changes have unfortunately a 'motherhood' ring about them. They also seem extraordinarily remote, no doubt, from the barriers-to-economic-adjustment question. Nevertheless, I would reply to the first objection that it has been, and will continue to be, extremely difficult to bring any of them about, motherhood or not. Why would a majority government acquiesce in the adoption of any of them? As to the second objection: I would suggest that the seemingly pragmatic 'solutions' ordinarily proposed by economists have usually turned out to be more dogmatic than pragmatic. If anything, the political market has been encroaching upon the economic market at an ever-increasing rate in the last several decades. As I have argued repeatedly above, we have reached a situation where the expected rate of return on investments in securing favourable political decisions often exceeds that on conventional assets. The advice of economists has been largely ignored by policy-makers for the simple reason that they would have cut their own throats had they heeded it.

The relative weight of the common interest at the policy bargaining table - and that is what most government decision making is all about - needs to be increased. Only then are we likely to achieve both a better balance between the more efficient allocation of resources that would be achieved by permitting unfavourable market adjustments to occur and the sharing of the burden of adjustment. Only when the common interest has more power and influence are the negative sum games less likely to take place. We must find a better way of bribing the losers to accept their losses.

The problem of inducing government to in turn induce Canadian industry to take greater advantage of the opportunities afforded by international economic developments is similar in some respects. I would suggest that we have, so to speak, a comparative <u>dis</u>advantage with respect to innovation arising largely from the massive presence of foreign subsidiaries in Canada. (This is not to argue that there has been no net

benefit from foreign investment.) Furthermore, our tariff, which was largely responsible for the presence of these subsidiaries and branch plants, also unduly restricted competition. This lowered the quality of Canadian entrepreneurship. In the past we could 'afford' to be inefficient and unimaginative because we had our resource rents, largely derived from our exports, to squander. An inordinate proportion of our research was financed by government on a feast-or-famine basis. Heavy reliance on this source of financing, together with the weak demand for applied research by Canadian industry, resulted in too little emphasis on applied and developmental research. The pure research generated was of course a gift to the world, as were our science and engineering graduates who could not find comparable employment opportunities here and therefore emigrated. Too frequently, in other words, we have not taken advantage of our own collective investment.

There are, I would suggest, a considerable number of narrow interest groups that have a considerable stake in preserving this status quo. And the status quo is inimical to the exploitation of the comparative advantages that can result from international developments. Here too I believe that increasing the relative bargaining power of collective interests relative to special interests is likely to result in some much-needed changes conducive to positive adjustments to international developments. But to elaborate upon this theme would require another paper.

In conclusion, I believe our decision-making structure is such that, in so far as international economic developments are concerned, Canadians too frequently play a game in which with heads the collective interest loses and with tails the collective interest loses too. And the domestic situation is little better. Part of the answer, if there is one, lies in some basic changes along the lines of those motherhood items listed above. Strangely enough, the 'family compact' arrangement that dominated public affairs in the early days of Upper Canada still seems to linger on in Canada as a whole. The quiet life no doubt has its own rewards. The barriers we erect to escape the adjustment to ever more frequent and dramatic international economic changes are, however, making such adjustment increasingly expensive.

Walter S. Salant

I confess that at first I had some difficulty is understanding the drift of Professor Hartle's paper, owing mainly, I think, to what I took to be a conflict between two strands of thought. One strand seemed to be that political incentives work against the pursuit of policies that would promote net long-run national gains when external changes occur. This seemed to refer to some specific policies that would promote these long-run national gains. The specific policies that would be necessary or desirable for promoting this objective were not stated explicitly, but as an economist I assumed that they would promote or at least acquiesce in an adjustment to market forces. This interpretation, however, seemed to conflict with another strand of thought that criticized this conventional policy goal of economists as too narrow and as merely a reflection of normative preference. Moreover, Professor Hartle himself seemed to be rejecting this goal, even when long-run gains would be greater than losses, on the ground that the compensation principle, according to which gainers could compensate losers, was irrelevant. In short, the second strand of thought seemed to leave uncertain what sort of policy is impeded or prevented by political incentives.

This thought left me wondering whether Professor Hartle means that political incentives work against <u>any</u> national policy goal that falls within his definition of 'industrial strategy.' That question arises because his definition is broad enough to include a policy that would give extra weight to 'special interests,' and which could be justified if what made those interests special was that gross losses were concentrated heavily on them. On so broad a definition of an industrial strategy, I found myself wondering how far one can press that more general thesis without examining the effect of political incentives on each of several possible industrial strategies one at a time.

This second interpretation seems to be supported by the statement early in the paper that its principal purpose 'is to explain why even a reasonably balanced concept of an industrial strategy based on a few reasonably plausible assumptions is unattainable under the prevailing government decision-making system' and by the fact that the definition of an industrial strategy is very general. It is a government policy or set of policies that classifies external economic changes into three categories and

implements the 'appropriate' responses. Without some definition of appropriate response, it seemed to me difficult to press the thesis that the political incentive system works against carrying it out.

The main type of decision that the paper finds unattainable appears to be the type that allows or encourages adjustments to changes that can be expected to have major long-term negative effects on specific industries, where abandoning them or phasing them out would be appropriate. It was not clear to me whether it is assumed that adjustment is always desirable even when it would result in net positive gains if compensation of the losers by the gainers is not feasible. If such compensation is not feasible I would raise the question whether the obstacles to such adjustments that are created by the decision-making process may not result in a rational or at least a sensible outcome, whether or not by a conscious decision to make the adjustment gradual, and regardless of whether the reasons given for the policy adopted are real or specious. Professor Hartle himself says that the maximization of net national wealth over the long term is only one of several possible goals of policy. That goal can be pursued without constraint, or it can be pursued subject to the constraint that no substantial group of individuals shall suffer more than some specific amount of economic loss or other injury, including the psychological injury of sudden displacement, even if the economic value of their losses in the aggregate is less than the aggregate of gains. Or the goal of policy can be that nobody below some specified level of income should be forced to suffer loss, irrespective of the aggregate gains of others. To a considerable extent I think that is what some of the political decisions that the paper finds inconsistent with an industrial strategy are doing, and I am not sure that a political process having that protective result, whether pursued deliberately or in response to some other special interest, is so bad. A policy that prevented substantial costs to individuals from being felt immediately might be 'appropriate', if I may myself use that weasel word, from the point of view of the country as well as that of politicians. In effect, I am asking whether responsiveness to special interests is not sometimes a good policy. It would be a happy circumstance if governments could always pursue long-term national economic benefits, but not if that were possible only at the expense of government's ability to govern, for that ability is what we want most of government.

It seems to me that what one might look for, instead of changes in the political process, is better ways of reconciling conflicting interests or reducing the intensity of conflict, such as promoting adjustment but, instead of letting it occur as fast the market would do without interference, slowing it up. Much of the burden of adjustment to change comes from the speed with which the market forces alone would force it to occur. Gradual adjustment is much easier, and if large aggregate gains are distributed over a very large number of people a delay in their realization does no perceptible harm. I have suggested ways in which this can be done in the case of increased import competition. (See 'The effects of increases in imports on domestic employment: a clarification of concepts.' U.S. National Commission on Manpower Policy, Special Report No. 18, January 1978, 39-59.) A good discussion of various goals of policy is to be found in Max Corden's book Trade Policy and Economic Welfare (Oxford University Press, 1974.)

I turn now to an analysis of the political process in the first section of Professor Hartle's paper. I have little knowledge of Canadian politics, and it would be presumptuous of me to comment on the validity of what Professor Hartle says that applies specifically to it. What he says about Canada seems to apply, broadly, to the United States, too: the concentrated effect dominates the dispersed one; the short run dominates the long run. It is true that in the United States, also, these are serious political obstacles to what an economist would regard as efficient policies.

In at least one way they are even more serious in the United States that in Canada. The executive has less control over the legislature in the United States than in a parliamentary system, owing to the fact that the terms of office of both the president and the members of Congress are fixed. Senators and members of the House of Representatives both have fixed terms of office and do not have to worry about being turned out of office before the expiration of their terms. Moreover, even within the Congress there is less party discipline. The control both of the houses of Congress by the president and of the party members of their leaders within the houses of Congress depends on the skill of the leaders and, in the case of the president, his political popularity, which influences the extent to which a legislator thinks his constituents would punish him at the polls if he deviates from the line laid down by the president. The effectiveness of presidential leadership is very much a personal matter,

however. One need only contrast President Lyndon Johnson with President Carter. (A good discussion of the sources and uses of political effectiveness can be found in Richard Neustadt's book, Presidential Power (New York: John Wiley and Sons, 1960.)

On the other hand, the fixity of terms sometimes works in the opposite direction, making it easier than in Canada for the leadership to ignore special interests. Because the president, once he is in office, need not worry about being displaced until the end of his term, he is free to do very much as he pleases in the first year or two of his four-year term, and also, since he cannot serve more than two terms, he is fairly free to offend some special interests in his second term. Similarly, senators can be free of worry in the first years of their terms or, if they are as well entrenched as many are, for much longer. Of course, the special interests know that and recognize that the effective place to exert pressure is on the Senate or the House of Representatives. Therefore, this may not be such an advantage as would at first appear.

Notwithstanding the validity of the points that Professor Hartle makes about the political process, I believe that the picture he gives must be regarded as rather one-sided. It explains too much. It explains the occurrence not only of things that do occur but also of things that do not.

As one example, consider that in the United States a liberal trade policy was enacted in the form of the Trade Agreements Act of 1934 and that its general line of policy has been pretty well maintained since, although the economic reasons given in defence of it were, from the point of view of an economist, wrong reasons. One could explain its original passage as an act of desperation in the depths of the Depression, but how is one to explain the continued passage of legislation that merely nibbled at it instead of overthrowing it?

Or consider the legislation supporting U.S. participation in the Multilateral Trade Negotiations, the so called Tokyo Round. At one time it was regarded as very doubtful that this legislation would pass. President Carter appointed, as the man to be in charge of the negotiations and the effort to get the legislation enacted, Robert Strauss, a man who knew nothing whatever about trade problems but who was of proven political skill. When he had finished his work the bill passed in the House of Representatives by a vote of 395 to 70 and in the Senate by a vote of 90 to 4. Strauss worked a political miracle, which a reader of Hartle's paper

would have to say was impossible. Or course, he bargained and me made concessions. I do not know the details, which would make a fascinating study. One known concession was that he promised the textile industry that it would be adequately protected by quotas. This concession suggests that he may have obtained passage of the legislation by weakening it so greatly as to make it without value from the point of view of trade policy, but I believe that nobody has shown that to be the case. He must also have promised some congressmen who would otherwise have opposed the legislation something they wanted on issues having nothing whatever to do with international trade.

In other countries, too, the obstacles to desirable national policy that Hartle enumerates must also operate, but trade policies that are liberal at least in relation to what special interests would want have been adopted there also. It seems clear, therefore, that the paper either exaggerates the importance of the obstacles or neglects political forces operating in the opposite direction or both.

I am not qualified to correct what I regard as this imbalance, but I can call attention to several points. One, as I have already mentioned, is skilful trading by individual legislators, which must play a role in securing this policy in the trade field, as in any other field of policy. Deals may be made about the application of a general policy to specific cases. Moreover, trade policy is only one among many issues with which legislators are constantly confronted. It is easy to forget this when one's attention is concentrated on policy in one field, but to forget it when talking about the political process leads to error.

Second, it is true not only of legislators but of their constituents that their concerns are diverse. Knowledge of that fact may dampen the opposition of legislators to a trade policy unfavourable to some of their constituents, and may also dampen the reluctance of a president or prime minister to offend important special interests. They know that they will be judged by the vast bulk of the electorate on general performance rather than on one specific issue, unless that is a very important issue to an important part of their constituencies.

A third point that is hard to be specific about should also be mentioned. In the United States at least, general ideology about trade policies must play a role. It was very common during the depression of the 1930s to attach a large part of the responsibility for it to the Smoot-Hawley

Tariff Act of 1930, probably more responsibility than was justified. Liberal traders seem to have persuaded the public of their views. Indeed, in what may be called the international relations establishment in the United States, commonly regarded as symbolized by the Council on Foreign Relations, belief in liberal trade policy was practically a requirement for admission to the club. I doubt that there was a single recognized 'expert' on international relations who was a protectionist, with the notable exception of John Foster Dulles. The rest were free traders by religion, often more ardent than economists. I say 'by religion' not only because of their fervency but because their versions of the economic arguments make clear that in most cases they do not understand those arguments very well, and because their non-economic arguments, centring on the contribution that liberal trade policies make to the maintenance of world peace, also seem to be based on faith, by which I mean belief without evidence.

I cannot resist thinking that the whole environment in which matters of trade policy are considered has been influenced by this ideology. Until import competition becomes severe and widely publicized, it is just not respectable in that community to be a protectionist; support for increased barriers to imports gives rise to feelings of guilt and calls for explanations that are not required when one is supporting liberalization, unless one's constituency believes that it is directly and substantially injured by competition from imports. This ideological consideration may not fit into any specific political formula, but I believe it is a necessary part of any explanation of why the commercial policy of the United States has survived to the extent that it has for almost fifty years.

I conclude, therefore, that what Professor Hartle asserts is largely correct, but that too much is missing. It is not what he says but what he does not say that prevents his story from being what I regard as balanced.

Michael Trebilcock

As one who has been profoundly influenced by Douglas Hartle through his many writings, informal conversations, and formal collaboration, I am an

improbable person to deliver a critical broadside on his paper. Indeed, I believe his paper, like his previous writings, serves an invaluable purpose in reminding us that public-policy-making is decision-making under important constraints. Just as we have always recognized that households make consumption decisions subject to budget constraints, and firms make production decisions subject to profit constraints, so, Hartle reminds us, do governments make decisions under political constraints.

These constraints derive from Hartle's assumption that political actors behave by and large from self-interest, just as actors in economic markets do. Thus, voters demanding policies and politicians supplying them will attempt to maximize their self-interest. In the case of voters, the nature of this interest will vary widely across classes of voters. In the case of politicians, in order to exercise power they must get elected and stay elected, i.e. maximize votes. Thus, political decision-making becomes an exercise in brokerage among competing voting interests by vote-maximizing politicians.

Hartle points out that the competition among voters for favourable collective decisions is imperfect in various important ways. On the demand side, some voters face higher costs of information and organization than other voters, which leads Hartle (and others) to suggest that highly concentrated (e.g. producer) interests will often dominate highly diffused (e.g. consumer) interests. On the supply side, the fewness of 'firms' (parties) in the political market reduces, or at least distorts, competition among them for votes. Moreover, because of the short time between elections the parties apply extremely high discount factors to the future consequences of their policies.

Hartle's analysis of political markets, with these imperfections, leads him to a bleak view of the likelihood that governments will adopt 'rational' policies in economic matters. Rational, from an economist's perspective, might be taken to refer to policies that enhance the value of social resources, i.e. maximize national income. Thus it is argued, for example, that the prospects are remote for rationalizing domestic industries in the light of a changing international economy.

In general, I find Hartle's thesis very compelling. However, I believe there is a danger that it overstates the forces of economic irrationality. James Buchanan in his book, The Limits of Liberty (Chicago: University of Chicago Press, 1975), argues that collective decisions must

be viewed as falling into two classes: 'constitutional' and temporal. Influenced by John Rawls's book, A Theory of Justice (Cambridge Mass.: Harvard University Press, 1971), Buchanan adopts a 'contract' theory of the political process. He argues that constitutional rules, i.e. the rules under which collective decisions are made, are much more likely to enshrine or protect notions of collective welfare than decisions that emerge from continued pragmatic and incremental situational response, informed by no philosophical precepts.'[1]

We in fact observe constitutional constraints on self-interested behaviour in a wide variety of social and political activities. We observe sports games played by accepted rules; voluntary associations with constitutions; nations with constitutions; international conventions and international law (e.g. the Geneva Convention; diplomatic immunity); and, important in the present context, international treaties such as GATT. In other words, while conflict drives Hartle's model of the political process, consensus widely establishes the constraints within which the self-interest of the actors may be maximized.

There appear to be two main reasons why political actors may sometimes accept constitutional constraints on self-interested behaviour. Both relate to the imperfections in the political market that are described above: on the supply side, short time horizons; on the demand side, asymmetries of information and organization. With respect to the first imperfection, the time horizon over which constitutional rules apply is generally much longer than for other rules. Thus, political actors find it much harder to predict the possible effect of these rules on their interests, and this redirects attention to broader, less self-interested, and more aggregated notions of social welfare. At this level of generality, it will sometimes be accepted that, by and large, to reject the proposed constitutional constraints on political behaviour may lead to a negative or mixed sum game of the kind generated in an unconstrained majoritarian political system, in which the winners (if any) and losers are difficult to predict.

Obviously, constitutional consensus is more easily attained behind Rawls' hypothetical veil of ignorance where citizens choose constitutional arrangements in assumed ignorance of what fate holds in store for them. In the real world, as Canadians know better than most, constitutional

1 Ibid, 167

consensus must be sought against a background of very varied endowments. For example, poor persons (or provinces) are unlikely to agree to give up the possibility of achieving favourable redistribution at the expense of rich persons (or provinces) by political means, at least without substantial compensation. However, even here, the long periods of time to which constitutional rules often apply make it difficult for the actors to be certain of their relative endowments over time. Newfoundland is a current example.

As to imperfections in the political market on the demand side, decisions on constitutional rules are less afflicted by asymmetries of information and organization costs than day-to-day, low visibility, resource-intensive, collective decision-making (of the kind typified by regulatory proceedings). The once and for all, more aggregated character of constitutional decisions may permit interests that tend to be under-represented in normal collective decision-making (e.g. consumers) to exert a greater influence on the decisions. In other words, the costs of influencing collective decisions may differ depending on where the decisions are made. When Anthony Downs[2] asserts that, for example, tariff policy always exhibits a pro-producer, anti-consumer bias because of the differences in political effectiveness between concentrated and diffused interest groups, his thesis fails to explain why we have had any tariff reductions at all. Similarly, the adoption of Proposition 13 in California, which in effect countermands prior collective policies supplied to various interest groups (which presumably still exist), can be explained both by its breadth of application and the length of the time horizon to which it applies (as a constitutional amendment).

However, the way in which constitutional rules offset imperfections in the political market on the demand side also implies an important reservation that is likely to reduce the effectiveness of such rules. Given that governments usually have a range of policy instruments with which to pursue their goals, if constitutional constraints prevent them from using some of those instruments, they are likely to use others instead. In international and inter-provincial trade we have classic examples of this in the substitution of non-tariff barriers to trade for tariff barriers, which in part undermines the constitutional constraints contained in the GATT

2 Anthony Downs, An Economic Theory of Democracy (New York: Harper and Row, 1957) p. 255

treaty and s. 121 of the BNA Act.[3] These substituted instruments (e.g. government procurement policies, discriminatory standards, subsidies, quotas, customs valuation procedures) are generally used in a day-to-day, low visibility, ad hoc fashion that cannot easily be resisted by interests that may have favoured the initial constraints. The informational and organizational disabilities of such interests (usually widely diffused consumer interests) become severe in this disaggregated form of decision-making. Clearly there are strong political forces at play that promote these substitutions. Rather as in classic cartel theory, there is only one thing better than a cartel for a participant and that is to be able to cheat it. There is only one thing worse than to be caught cheating, and that is to have no cartel at all. Thus there will be a tendency for affected interests to accept tariff reductions and seek to undermine them with substituted instruments - this is arguably the worst of all possible worlds in social welfare terms. Ensuring that the initial constitutional constraints can be enforced is a major challenge to lawyers and others concerned with such issues. The recent GATT Codes on non-tariff barriers are a modest but important attempt to come to terms with this problem. Domestically, discussion of the desirability of a code of economic conduct (presumably having constitutional status) to prohibit provinces from erecting non-tariff barriers to interprovincial trade suggests another promising avenue of 'constitutional' return.

In summary then, what I am arguing is that both internationally and domestically there may be some room for rational adjustments to new forces in the economy. However, the success of these adjustments depends critically on the successful promotion of effective constitutional constraints on self-interested political behaviour. Short of this, we are left with the world that Hartle has described, and with it the implications so soberly laid out by Henry Simons in Economic Policy for a Free Society (Chicago: University of Chicago Press, 1948) p. 70.

> A nation which wishes to preserve democratic institutions cannot afford to allow its legislatures to become engaged on a large scale in the promiscuous distribution of special subsidies and special favours. Once this occurs, there is no protecting the interests of the community at large, and, what is more important, there is no protecting the political institutions themselves. Tariff legislation is politically the first step in

3 Section 121 provides that goods produced in one province must be admitted free into another.

> the degeneration of popular government into the warfare of each group against all. Its significance for political morality is, moreover, quite potent. Against the tariff, all other forms of 'patronage' and 'pork barrel legislation' seem of minor importance.

Although constitutional reforms, as I have used the phrase, are difficult to achieve, they offer grounds for cautions optimism by making the political decisions more congruent with economic rationality. Otherwise, we must resign ourselves to a counsel of despair. Like Buchanan, I prefer, for the time being at least, to believe that 'history need not be a random walk in sociopolitical space' (ibid, 67).

Discussion

D.G. HARTLE: I guess I don't really feel quite that pessimistic either. One has to proceed on the basis that improvements can be made, that conditions are not absolutely hopeless. On the other hand I think it is also very dangerous to make the opposite assumption, as economists seem to do, that these adjustment processes not only are desirable but will fall into place. The paper tries to point out the enormous political barriers to doing what economists think is so obviously required. Maximizing economic welfare per capita GNP, say, is not the sole objective. Nor is ther any reason to believe it should be.

The economist's job presumably, is to explain the opportunity cost of, say, a change in distribution of income in terms of maximum output forgone, but I see no particular reason why that cost should not be paid as a personal matter or not be a decision that politicians constantly have to make.

As for constitutional rules, I certainly accept the fact that these rules do provide a kind of basic structure that prevents coercion of minority groups. I am not so sure that it prevents the coercion of the majority by special interest groups. There is a limit to coercion; it does eventually lead to demands for changes in the constitution.

For example, consider equalization payments from the federal government to the have-not provinces which are not written into the constitution but might just as well be. Many of these so-called constitutional changes

essentially impede the economic adjustment processes.

I do not think that the world is a jungle, I just think that it is designed to keep the winners winning and keep the losers losing.

As for the question of tariffs and GATT, I will believe that the general tariff reductions are for real when we have seen the end of the non-tariff barriers that I expect all of the participants thought they could use to cheat.

As for the adjustment process continuing in Canada, the textile industry, boots and shoes, furniture, etc., show many more instances where industries that have been hurt by tariffs or would be hurt are somehow sustained.

I wonder if the American attitude towards reducing tariff barriers will persist in the face of, let's suppose, the decline and potential extinction of Ford after Chrysler. I wouldn't hold my breath for it.

I agree that a kind of implicit logrolling goes on all the time, but it basically amounts to stopping the adjustment when it applies to a specific industry or community.

COMMENT: I find myself very impressed by Doug's paper, but as both Professor Trebilcock and Professor Salant indicated I find it hard to be as pessimistic.

Following Salant's lead in adding to the list of elements left out, I think we would first of all have to end a Prime Minister and a Cabinet.

There exists a machinery that does more than deal with special interests and special cases one at a time, which is forced to pull the stuff together.

It may well be that the notion of peer groups politically is not the sort of thing that matters so much nowadays as it used to, but I don't think that peer group structures in political relations have totally disappeared. This is a kind of generalization of the point that Salant was making about the international affairs community.

My third point is that in political life, as in the political markets and in many of the non-political markets, there is a lot of toing-and-froing, waste motion, charade, and so on. We have to distinguish between that and reality.

I haven't had as much experience as Doug, but I have sat in with ministers receiving and talking to assorted delegations. There is a lot of

polite conversation that is merely that. It is just part of the fuzz-and-foam of political life, and one should not mistake if for the reality of political life.

Fourthly, even though government interference, for better or worse is pretty substantial, in a lot of areas it is really not overwhelming. The most powerful forces are still the private decisions. Despite the efforts at protection this country has lost a piece of its textile industry, and there has been a tremendous transformation in the conditions of textile workers.

Again, I find it hard to be as pessimistic about adjustment as Doug is, in part because I think there may be a tendency to over-rate the importance of government.

COMMENT: An additional link which would be a useful supplement to the comments by Professor Trebilcock and Dr Salant would be the notion of dialectics, that is, you can only favour the narrow interest group at the expense of the broad public for so long, and that eventually knowledge of economic losses to the broadly based group does seep through. It may take a long time, but ultimately it happens, and when it does it can be mobilized by the media. I would argue that this link may be behind such things as the recent deregulation of airlines, as well as the general post-war tariff reduction movement.

D.G. HARTLE: I suppose so, but would you imagine, for example, that agricultural marketing boards are on the way out? I can think of a few instances, such as deregulation of U.S. airlines, and possibly we may have that here. But I can't imagine that happening to highway transport in Canada.

The instances where adjustment has in fact taken place are fewer in number than the instances where governments have prevented the adjustment from taking place, and certainly they enormously protract the problem.

Eventually I suppose the adjustment does indeed occur. Over twenty-five years or so, for instance we have got a smaller textile industry than we once did.

For an industry concentrated in the community, such as mining and pulp and paper and some others, this phasing-out business is no mean feat politically, and not easy to get the adjustment processes that most econo-

mists think will fall in place. People do not want to move. Scheme after scheme essentially makes it possible for people to remain, say in the Maritimes over a century, by moving the resources to them.

QUESTION: The windfall profit tax that has recently been passed in the United States is a further example of compensation for losers and provides that the winners do retain some of their positive benefits. Now again the utilization of this compensation mechanism would, I think, lessen the pessimism in your predictions. I would like to hear your comments on the possibility of the utilization of this kind of compensation mechanism in the Canadian context.

D.G. HARTLE: I would have thought the most general form of compensation - the tax in fact does not deal with the problem of human capital unfortunately - going to a full taxation of capital gains with full deductibility and even refundability of capital losses at, let's say, 50 per cent would indeed be an automatic way of slowing down the winners, reducing the antagonism towards them, and would also have an automatic compensation to the losers built in.

But every tax system I know of is asymmetrical and taxes the gains but provides inadequate offsets on the loss side. Politicians can't abide the thought of returning people's money or having them carry it forward and never pay taxes again in their lives.

Leaving aside the human capital aspect, which of course is enormously important in voter terms, on the capital side I think that this would be the most simple and direct and obvious way of dealing with this problem of compensation.

It really requires the symmetry of treating losses and gains in exactly the same way. In principle that would be a much better solution that attempting to prop up bits and pieces here, there, and everywhere.

In a sense we do have for the human capital side things like unemployment insurance, which of course is a temporary phenomenon; but if the same could somehow or other be done for the capital side it would be better than what we have at the monent.

Strangely enough, the failure to tax capital gains in full, which is then used to rationalize not giving the full deductibility to losses, I think makes the adjustment process much more difficult than need be.

COMMENT: My training in economics has led me, like you, to be somewhat opposed to things like milk marketing boards, egg marketing boards, and so on. But my question is why so little work has been done by economists at estimating the social costs of these special interest groups?

In other words, it seems impossible to come up with a decision calculus in political terms, but a first step would be to come up with a decision calculus in economic terms. Why has this not been done explicitly?

D.G. HARTLE: The only marketing board study I am familiar with is the one that was done on the Treasury Board some years ago on milk marketing boards. In essence it showed, as I think most studies show, that the amounts are relatively trivial in static efficiency terms.

The real issue, of course, is distribution of income.

So that study was not pushed forward even inside the government for the simple reason that there was no way to persuade politicians to stir up that hornet's nest for a small efficiency gain.

The real issue was distribution of income, and that was nothing, of course, that economists had anything to say about.

In this particular instance, therefore, the only one I really know, the analysis for the efficiency losses was so precarious that no politician would be persuaded of it.

If they win dozens and dozens of seats on the basis of these marketing boards, how many seats would they gain if they got rid of them?

Among the enormous groups of, if you like, middle-class and ordinary people these issues are either not understood or simply not worth fighting about. Of course they always get stabbed ultimately. But there is a good deal of logrolling going on where large numbers are conned into believing that they are getting a march on somebody else. So the politicians are able to play these games. I am not saying they always do so successfully; they sometimes do get defeated.

Ontario: policies and problems of adjustment in the eighties

Douglas D. Purvis and Frank F. Flatters

The problem we have been assigned involves the formidable task of predicting the changes in key exogenous variables that will occur in the 1980s, examining the implications of these changes for the Ontario economy, and evaluating the policy options. Given that we do not have a crystal ball, our response to this assignment is, of necessity, incomplete. Had we had access to an econometric model - a useful tool but nevertheless a poor substitute for a crystal ball - we could have at least made a wide variety of simulations of the 1980s and used those simulations as a starting point. Unfortunately that was impossible in the time available to us.

How then to proceed? Our first reaction was dismay. The 1970s were a decade of enormous upheaval and change in the international economy, and also in Canada. It is not unfair, we contend, to suggest that many of the events of the 1970s are as yet incompletely understood by economists, and it seemed to us that if we were unable to 'forecast the past' then it was impractical to speculate about the future.

Upon further reflection, this apparent difficulty appeared to us to be, in fact, a useful way to approach the issue, and so it becomes the theme about which we have organized what follows. Indeed, it is true that understanding the events of the 1970s presents a challenge to economists. But a large part of the challenge is of interest only because adjustment to those events, including the reaction of economic policy, is incomplete. The events of the 1970s set in motion forces that have implications for the 1980s; those developments of the 1980s form the starting point for our analysis.

This paper was revised on June 1980. In revising it we benefited from comments made by our discussant, Kevin Clinton. We are also happy to acknowledge helpful comments from David Longworth and useful discussions with John Helliwell, Ken Norrie, and Peter Sadlier-Brown.

In the next section we provide a brief catalogue of major events of the 1970s that interest us and outline their relevance for Canada and, in particular, for Ontario. The general impression that emerges is that the Canadian economy has fared comparatively well in the 1970s, and is in pretty good health; however a number of causes for concern for the 1980s can be identified. In particular, forces can be identified that suggest a coming decline in the Ontario manufacturing sector and shift in economic activity towards the west, especially Alberta. The various aspects of this shift are the subject of much of this paper.

Not surprisingly, one of the major events of interest to us in the 1970s was the dramatic increase in the world price of oil and other energy sources and the gap between domestic and world prices that has emerged.[1] Hence we review briefly some aspects of the debate concerning raising the Canadian price of oil to parity with the world price. To date the focus of the debate has been on distributional issues, and we conclude that no convincing argument against parity has yet emerged; in light of our title, we could at this stage be accused of playing devil's advocate! However, two aspects of the issue related to efficiency in resource allocation have been incompletely considered. These are the issues pertaining to the implications for regional (or, more accurately, provincial) resource flows and to problems of macroeconomic adjustment; these two issues then form the core of the paper, which is followed by some conclusions and suggestions for future policy and research.

A BRIEF PERSPECTIVE ON THE 1970s

The 1970s were a decade of major economic upheaval that posed a complex array of new problems for policy analysis and prescription. The general confidence that pervaded economic circles about the 'death of the business cycle' and the success of the 'neoclassical synthesis' has not survived the decade, and issues pertaining to stablization policy and the role of government in allocation are again major sources of controversy. Here we review very briefly some of the major events of the seventies with an eye to giving some perspective to the economic problems now facing the Ontario

1 Our main resource has been the excellent two-volume proceedings of the Ontario Economic Council's 1979 conference Energy Policies for the 1980s: An Economic Analysis, hereafter referred to as OEC (1980).

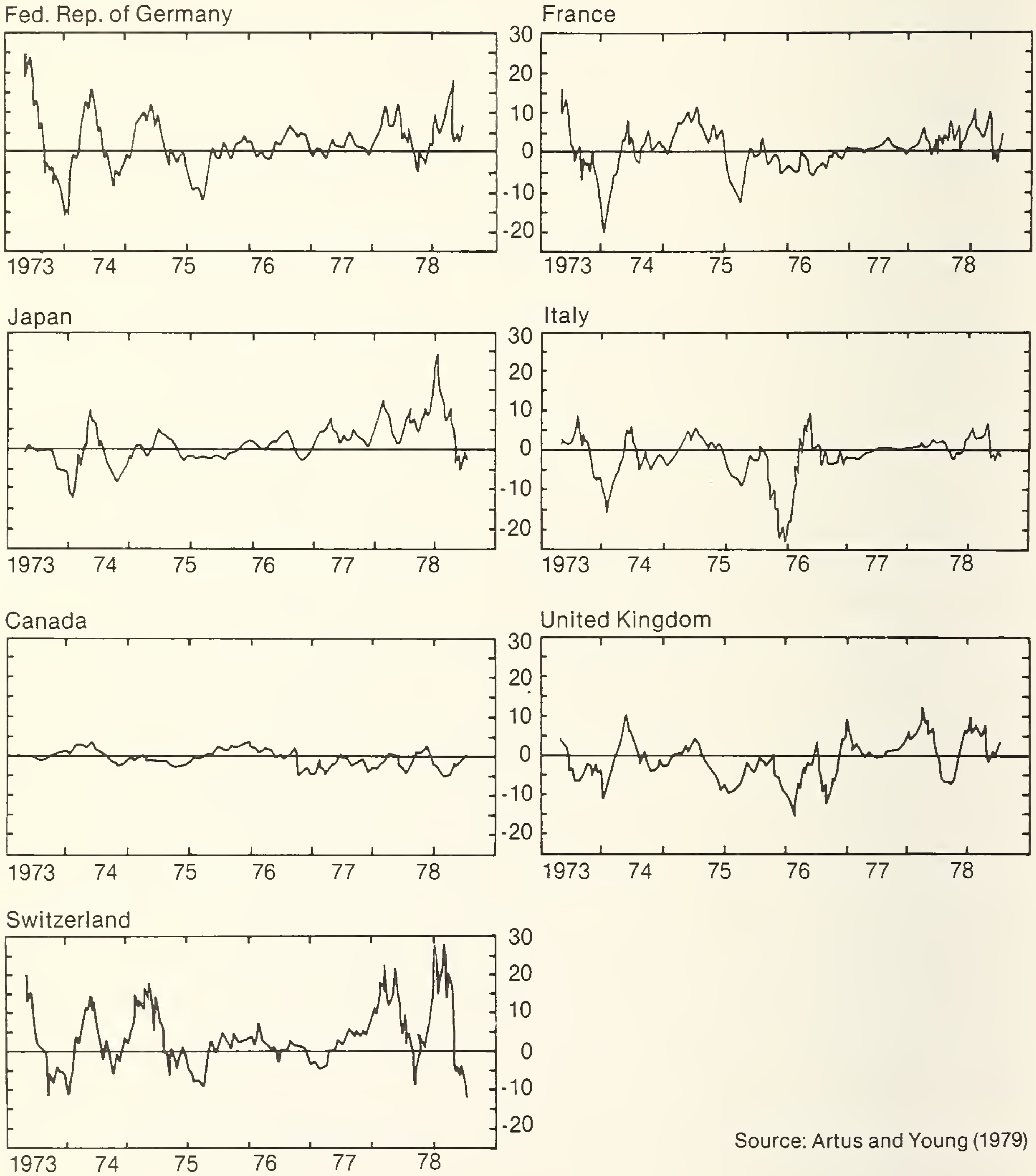
economy.

In May 1970, after a record quarter trade account surplus and in the face of large and growing capital inflows, the Canadian dollar was allowed to appreciate significantly. As it turned out, this signalled a more general movement towards floating exchange rates. In August 1971 the United States abrogated the Bretton Woods agreement, made the dollar inconvertible into gold, and forced other major countries to appreciate their currencies against the U.S. dollar. This was followed by the Smithsonian agreement in 1973, which led to the current situation of general (dirty) floating. Such floating has not turned out to be a panacea for international problems. The variability of exchange rates in the 1970s, as shown by Figure 1, has been much greater than economists predicted or than can be readily explained by current models. Furthermore, the variability in nominal exchange rates has been associated with large and rapid changes in real exchange rates, measured in terms of real wages or the ratio of traded to non-traded goods prices, and this has led to large swings in relative unemployment rates, inflation, and international competitiveness. We return later to a more detailed discussion of these issues in the Canadian context.

In Canada the exchange rate played a central role in the policy debate, despite the fact, obvious from Figure 1, that in terms of short-term variability the Canada/U.S. exchange rate has been extremely stable in relation to any others illustrated. For the purpose of this paper, two related developments are worthy of attention. The first concerns the early period of the float when the international economy accelerated into two-digit inflation; the second concerns the latter part of the decade associated with the depreciation of the Canadian dollar.

Looking first at the early part of the decade, we would maintain that the revaluation of 1970 was caused primarily by the tight monetary policy of the late 1960s. After the float, inflation was low and falling, and the major unemployment costs of the anti-inflation policy had been paid. Canada was in an excellent position to sustain this low-inflation/ low-unemployment position in the face of the acceleration into two-digit inflation by her major trading partners in the 1973-5 period; this would have involved letting the Canadian dollar appreciate. As is well known we failed to do so by following inflationary policies and stabilizing the exchange rate, though not by 'dirty float' policies of direct exchange market

Figure 1
Short-run variability in exchange rates in terms of U.S. dollars,
2 April 1973 - 31 December 1978



Source: Artus and Young (1979)

intervention but by a 'dirty fix' through excessive monetary expansion.[2] The parallels to the current (May 1980) situation are striking, and one hopes that the lesson has been learnt. From Ontario's viewpoint, the lesson is that the benefits from a low value of the exchange rate are very short-run. Those export industries that seek protection by arguing for an undervalued dollar are inviting imported inflation and consequent rising costs; their real long-run position will not be much altered.[3]

The second episode of interest is the events of the latter part of the decade leading up to the present low value of the Canadian dollar. Figure 2 shows that the Canadian dollar is the only major currency to have depreciated against the U.S. dollar since 1976. (Sweden had a major devaluation at the beginning of the period, but the krona has steadily appreciated since). The steady decline in that period reflects the fact that although the short-term variability from Figure 1 was small, almost all post-1976 quarterly changes were negative.

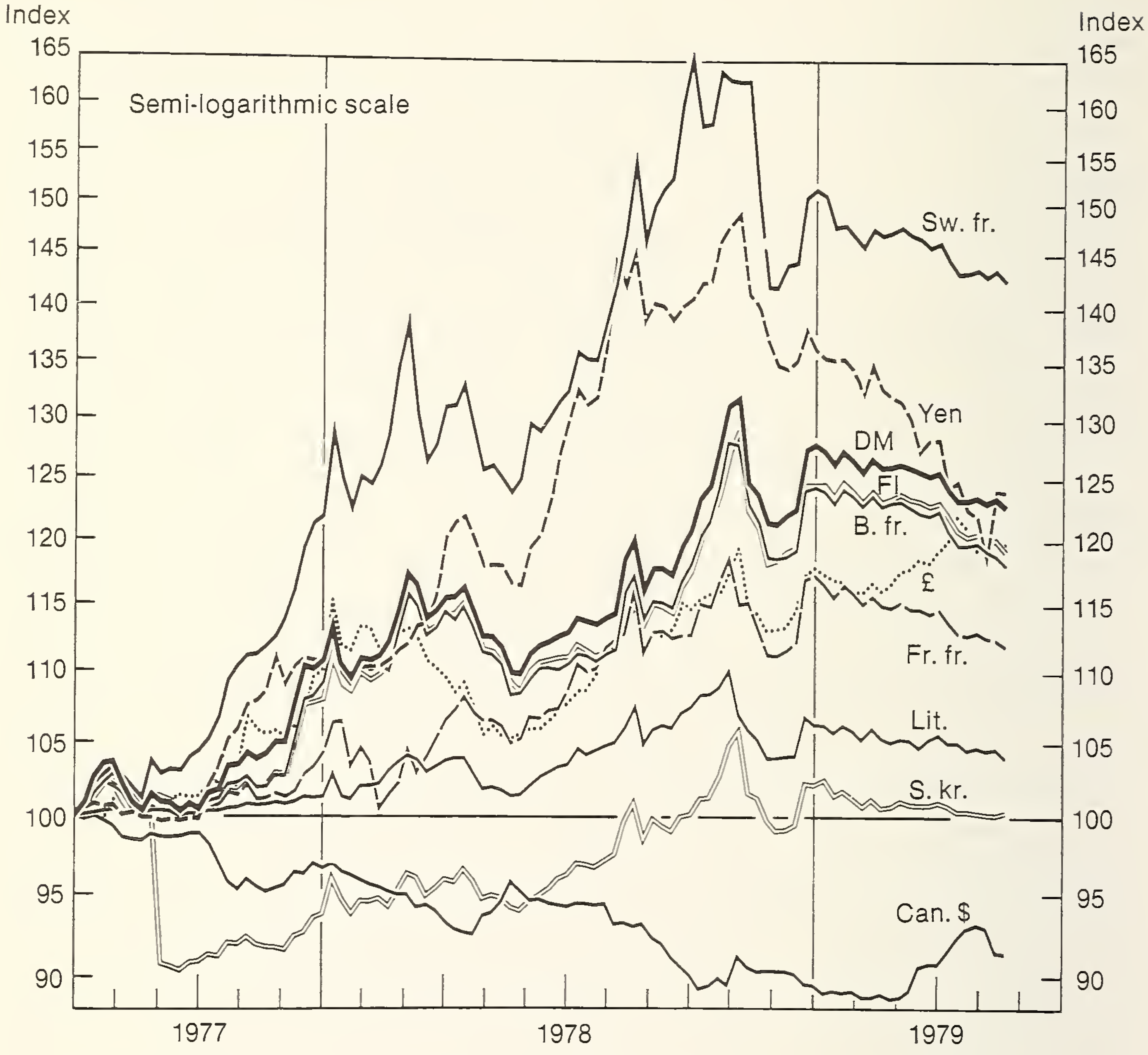
Two aspects of Figure 2 warrant mention. First, although the initial fall in late 1976 and early 1977 immediately followed the election of the Parti québécois in November 1976, it can be explained by basic economic factors. Canada had inflated faster than the United States in 1975, and by consensus the appreciation in the pre-1975 period then meant that by 1976 the Canadian dollar was overvalued. This was sustained for a time by large capital flows, and especially by large borrowing by the Ontario and Quebec governments. To the extent that the Quebec election precipitated a reduction or reversal in these capital flows it could be said to have 'caused' the depreciation. But in fact that early depreciation was a reaction to prior movements in relative price levels.[4] The issue is this: has the exchange rate 'over-shot' and is the Canadian dollar now so undervalued that one might soon expect a 'real appreciation' to the detriment of

2 See, for example, the discussion in T.J. Courchene (1976) or Purvis (1977). For an excellent detailed analysis of factors influencing the exchange rate over this period, see Charles Freedman (1980).

3 The morning that this paper was read to the conference (4 June 1980), the Globe and Mail reported that the Bank of Canada was intervening to prevent the dollar from appreciating in order to protect the competitive position of the manufacturing sector. In the words of Helliwell's paper for this conference, one hopes that they are leaning against the wind in the face of a transitory disturbance rather than avoiding the adjustment required by a permanent disturbance.

4 It also means that in this instance the depreciation was largely a result of inflation, not a source of it. This problem of sorting out

Figure 2
Selected nominal exchange rates vis-à-vis U.S. dollar 1976-9



Source: Bank for International Settlements, *Annual Report*, 1979

Ontario's export industries? (This issue of distinguishing real from nominal exchange rate movements is amplified below.)

'imported inflation' under flexible exchange rates is still important, but we shall largely ignore it. Note its importance, however, for the early 1979 wage formation-exchange market intervention controversy.

The second interesting aspect of Figure 2 is the extent to which exchange rate comparisons with the United States alone are very misleading in the 1976-80 period.[5] Other currencies, notably the Swiss, German, Japanese, and British, have all appreciated considerably vis-à-vis the U.S. dollar, so that the Canadian dollar has depreciated even more in relation to these other trading partners. (See also columns 1 and 2 of Table 5.) Again, however, the issue of real as opposed to nominal exchange rates is important since one could argue that the U.S. dollar is undervalued in relation to these other currencies.

These changes in the exchange rate in fact reflected other international events, including of course the dramatic movements in the price and availability of oil, related movements in other energy sectors, large swings in the current account balances within the non-OPEC western countries, and increases in prices of foodstuffs and raw materials. In Canada these were accompanied by domestic disturbances such as the increases in labour force participation rates and other demographic shifts, the emergence of Quebec separation as a central political issue, the reversal of the previously standard pattern of net long-term direct capital inflows to one of net outflows, the growth of the public sector and the phenomenon of public sector strikes and related labour-management problems, two episodes of incomes policy, and, of course, all manner of constitutional crises. Table 1 summarizes the behaviour of some major economic indicators in the decade.

Table 1 shows clearly the contractionary effects of the tight monetary policy of 1969-70 in the unemployment and inflation figures for 1970-2; the 1973 figures show the initial effects of th expansionary policies of 1971-3. Wage settlements were quite high during this period, reflecting in part substantial productivity gains. As the world economy moved into the inflationary phase of 1973-5, the Canadian economy followed suit and wage settlements continued to grow; in 1974 and 1975 wage settlements grew at 13.1 and 13.9 per cent respectively. These events led to the institution of wage and price controls in October 1975, although more detailed examination of quarterly data would show that wage settlements had started to decelerate before the institution of wage and price controls. The 1974-6

5 This of course applies to Figure 1 where it would have been preferable to illustrate the availability of trade-weighted effective exchange rates.

period is interesting as an example of supply-shock-induced stagflation with simultaneous increases in inflation and unemployment; the downturn was reflected also in a reduction in the volume of merchandise exports, as well as total and per-man-hour measures of manufacturing output. The post-1976 period, dominated on the policy scene by monetary targeting by the Bank of Canada, reflects a fairly stable pattern of recovery. The evidence suggests substantial growth in real wages during the first half of the decade followed by moderation or even decline since 1976. Compared with our major trading partners, and especially with the United States, our macroeconomic performance over this period looks pretty good. We note also that our balance on merchandise trade has also made a steady recovery so that no direct evidence of de-industrialization is apparent on that score. All of these developments have important implications for Ontario in the eighties, and any could itself be the subject of a paper. For a number of reasons (including that given in footnote 1 above) we have chosen to focus on the rise in the price of energy, in particular, the price of oil, which triggered the great stagflation of 1974-6 and continues to pose a formidable obstacle to real economic growth and stabilization in western economies.

The world price of oil increased approximately fourfold in 1973 when the major oil exporting countries (OPEC) agreed to co-operate in setting prices. While the nominal price rose in the ensuing six years, it failed to keep pace with world inflation so that the real price of oil steadily declined over that period. This was not, however, evidence of the collapse of the cartel, and the real price rose again in 1979. There now seems to be every reason to believe that the real price will be sustained and will probably even rise moderately over the next decade. The events leading up to this happening are complex, and from the vantage point of 1980 one could even argue that the price increase was predictable. But for present purposes, we treat it as an unexpected and, from the Canadian viewpoint, exogenous disturbance.[6]

This shock had two main effects on the world community: one was the adjustment problem inherent in the resource reallocation necessitated by the change in relative prices; the other was the wealth transfer from

6 We also disregard the related questions of how the OPEC cartel is maintained and if the OPEC-set price actually differs from the competitive price that would prevail in the absence of collusion.

TABLE 1
Summary statistics of canadian economic performance, 1969-79

			Percentage annual growth rate of				
	Unemployment	Inflation[a]	Manufacturing wages	Output per man-hour manufacturing[b]	Manufacturing production	Volume of merchandise exports	International balance on merchandise trade account ($million)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1969	4.4	4.6	8.4	-	-	-	964
1970	5.7	3.9	8.3	-	-	-	3052
1971	6.2	3.4	7.6	-	-	-	2563
1972	6.2	3.7	8.9	4.6	7.1	9.4	1857
1973	5.5	5.1	8.8	4.5	9.8	11.4	2735
1974	5.3	8.8	13.1	1.6	3.7	-3.8	1689
1975	6.9	10.0	13.9	-2.3	-6.3	-7.2	-451
1976	7.1	9.4	8.8	4.6	5.6	9.8	1388
1977	8.1	7.8	7.0	4.8	2.8	8.9	2737
1978	8.4	6.4	6.6	-	7.8	9.6	3382
1979	7.5	7.9	7.5	2.9	3.3	2.4	3985

a Annual percentage change in Consumer Price Index excluding food
b Output series not directly comparable to column 5

SOURCE: All except column 4 from Bank of Canada Review; column 4 from Canadian Statistical Review, October 1978.

oil-consuming to oil-producing countries. The international press has focused on the latter in its various political, financial, and other manifestations: discussion of the transfer problem, the recycling problem, the dollar crisis and the like are common.

We wish to focus on the former - the problem of resource allocation and macroeconomic adjustment. The importance of this problem is brought home by noting that among the western, industrialized nations, those with oil have not fared systematically better in the post-OPEC period than the countries without oil. Policy makers in the UK and Norway, for example, appear to be as concerned about future price rises as those in Germany or Sweden.[7]

That this should be so seems at first rather surprising, since by standard microeconomic arguments, countries that are net exporters of oil should gain from price increases. Their troubles reflect the seriousness of macroeconomic adjustment problems, commonly called 'the Dutch disease' because of the Netherlands' experience of the 1960s when they discovered and developed large North Sea fields of natural gas. We return to this in detail below, where we argue that Canada and Ontario have so far not been victims of the Dutch disease but that there are symptoms that suggest the likely emergence of a strand of the disease in the 1980s.

Canada's response to this increase in world price appears especially perverse if looked at in terms of annual trade flows (See Table 2). Export volume declined substantially throughout the period 1972-9, reaching a low of ninety-eight million barrels in 1978 after a peak of 420 million in 1973, a decline of 77 per cent. Imports were much steadier, declining by 32 per cent over the same period. Net exports fell by three hundred per cent from 60 million barrels in 1972 to minus 116 million barrels in 1979; the nominal balance moved from a $325 million surplus in 1972 to a $2 billion deficit in 1979.

Projections for 1980 and beyond are even more dramatic: exports rapidly become negligible, while imports are expected to grow sharply (some forecasts are as high as 400 million barrels in 1980); both events reflect a substantial cut in domestic production, which can be partly if not entirely explained by the deliberate policy of not allowing the prices facing Canadian consumers and producers to rise in accord with world prices.

7 Oil, it seems, creates a lot of friction.

TABLE 2
Canadian trade in crude petroleum, 1972-9

	Volume of exports[a]	Volume of imports[a]	Net exports	
			Volume[a]	Value($million)
1972	341.3	281.7	59.6	326.0
1973	420.1	327.6	92.5	542.1
1974	332.2	291.2	40.4	762.8
1975	194.7	298.4	-103.7	-1041.6
1976	182.7	276.9	-94.2	-993.4
1977	120.9	239.3	-118.4	-1464.7
1978	97.8	231.6	-113.8	-1898.4
1979	105.3	221.5	-116.2	-2073.9

a Volumes in millions of barrels
SOURCE: Statistics Canada

When the two-part price system was introduced, implicitly and then explicitly, the federal government also planned to adjust the domestic price towards the world price at $2 a barrel per year, but the world price movements outlined above have outstripped domestic price increases so that, in February 1980, the domestic price of crude oil was $14.75 (Canadian) a barrel while the world price was about double that. The low domestic production can be readily explained by the asset-holders' (oil companies') expectations of capital gains through increases in the price of oil; as Hotelling argued over forty years ago, if the price (actually, the net price accruing to producers) is expected to rise faster than the interest rate, it does not pay to produce for current sale. In addition to these resource allocation issues, the import subsidy involves large net federal costs - in the neighbourhood of $3 billion in 1980.

The issue of moving to parity with world oil prices can thus be seen as a central policy issue for Canada in the 1980s; not surprisingly, the question has been debated widely and has proved to be very controversial. We find it useful to divide the arguments into four categories: two are distributional and, as they have each been treated at length elsewhere, are only discussed briefly; two are allocational and, as in our opinion they have been somewhat neglected, we devote a later section to each.

Before turning to the distributional issues, there are two points about oil prices that we would wish to make at the outset. The first is that Canada is a small player in world markets and hence nothing that is done

in Canada will have any significant effect on the world price of oil. This means that whatever domestic energy policy evolves, and whether or not Canada becomes a net exporter of oil or remains a net importer, the social opportunity cost of the consumption of oil in Canada is the world price. Similarly, the marginal social product of oil production is the world price. Note also that this implies that conservation of oil and energy in Canada will have no effect on the future opportunity cost of oil in Canada. The second point is that a useful distinction can be drawn between two events that are often confused in the debate. One is a change in the world price of oil, i.e. an exogenous change in the social opportunity cost of oil. The other is a change in the relationship between the domestic and the world price of oil; in the rest of this section, we consider arguments relating to a movement to parity that involves no change in the social cost of oil.

The first distributional issue is foreign ownership. An increase in the Canadian price of oil will generate large 'profits' (or, more accurately, rents) for the oil companies since most current production is from low-cost sources; since the oil companies are foreign-owned, this represents a direct transfer from Canadians to the foreign owners.[8] Since these transfers apparently constitute pure rents and serve no allocative function, there is no apparent efficiency argument for making them. These considerations raise several interesting questions. Is there a moral, contractual argument for making the transfers? What are the long-term costs and benefits in terms of Canada's ability to attract foreign investment (particularly in exploration and development) of gaining a reputation for taxing away 'excessively' high returns to such investments? Should we also bail out foreign investors who suffer from an 'excessively' unlucky roll of the dice? However, these questions do not bear directly on the issue of parity since the net payments to foreigners can be more directly influenced by other tax, subsidy, and royalty schemes; see, for example, the proposals made by Hartle and Waverman and the ensuing discussion in OEC (1980).

What is clear is that the increase in <u>world</u> income resulting from

8 Approximately 80 per cent of equity in oil companies operating in Canada is held by foreigners - see Helliwell, OEC (1980, 90-1), where estimates of total rents and distributions thereof under various scenarios also appear. Of course oil price increases generate rents for equity holders only to the extent that expansion of oil production does not bid wages up; we discuss this in detail below.

movement towards parity would be substantial.[9] While we would agree that it would be preferable to capture a large part of this increase for Canadians (assuming it can be done without destroying the efficiency gains, along the lines of the Hartle or Waverman proposals), it would be bloody-minded to refrain from achieving parity on the grounds that some of the gains would go to foreigners. We do not believe that the issue of foreign ownership presents a serious obstacle to the argument for parity.

The other distributional argument pertains to the effects of parity on personal incomes; i.e. that the poor members of society are hurt more by price increases than the rich. This presumption that parity would be regressive seems to us to warrant further scrutiny. While certain oil related expenditures such as domestic heating are 'necessities' and therefore both inelastic and a decreasing share of income, large proportions are likely also to be very price- and income-elastic (size of car, maintenance of second cars, second homes, travel, etc.) so that oil price increases have considerable effects at the upper end of the income distribution. It would appear to us that the current policy of subsidizing oil results in an increased tax burden on all income classes and subsidies to upper income classes. Waverman's study, reported in OEC (1980), supports this view to some extent: he looks at expenditure patterns across income classes and finds that an oil price rise would not be regressive. Of course his results are preliminary and much more could be done; to be complete the analysis should also include the impact of parity on factor rewards. (For example, do the poor gain from an increase in the return to unskilled labour?) In any event, we concur totally with Waverman that even if suppressing the

9 In OEC (1980), Tom Wilson estimates the efficiency gains of a $1 increase in the price of oil towards parity to be 17½¢ while the transfer is estimated to be 20¢, so that Canadians would, in the current situation, be seen as losing from the establishment of parity. But in fact the standard errors of the two estimates are so large that there really is no significant difference between the two. Other estimates of this transfer to foreigners that were presented in OEC (1980) ranged from 5¢ to 21¢, suggesting that Wilson's 20¢ estimate might be too high. Clearly any work that increases the precision of this estimate would be of great value. In addition we should take into account the likelihood that any movement towards parity would be accompanied by an increase in tax rates on these rents, particularly by Alberta. (See the comments on the Scarfe and Wilkinson paper and Scarfe's reply in OEC 1980). Finally, all of the estimates of Canada's share of the efficiency gain ignore dynamic considerations related to Canada's relative position vis-à-vis development of other energy sources, energy conserving technology, etc.

price of oil does improve the distribution of income, it is a very poor and inefficient device for doing so. The income distribution effects of parity can be dealt with and should not be posed as a serious argument against moving to parity.

As stated above, the aspects of parity on which we wish to focus are the allocational ones. The next two sections examine the regional and provincial resource movements that will result from parity and the macro-economic adjustments.

REGIONAL DISPARITY AND ADJUSTMENT TO OIL PRICE PARITY

> If the windfall gain generated by the increase in world oil prices were shared by all Canadians the inducement to migrate to Alberta would be relatively modest. Conversely, if all the net collective benefits were retained by Alberta, they would eventually be shared by the migration of other Canadians to that province. In short, unless the province is able to close its borders to people, a slow but inexorable equilibrating process would occur if the collective benefit were sequestered by the province.
>
> -D.G. Hartle in OEC (1980, Vol. 2, 99)

Clearly the most obvious and perhaps the most significant implication for Canada of the existence of OPEC is the dramatic swing in regional terms of trade that it has brought about. There are two related aspects of interest: the regional reallocation of resources called forth by the relative price changes, and the complicated interaction between energy pricing and fiscal arrangements.[10] Although some aspects of these issues have been discussed elsewhere, we believe that insufficient attention has been paid to the first, and as a result discussion of the second has been hamstrung by the undue emphasis on the divisive distributional issues with their emotional appeals to 'equality' rather than on the mutual benefits of economic efficiency.

Consider first the efficient allocation of resources between, say, Ontario and Alberta as representative of oil-consuming and oil-producing regions. In a static-technology setting where labour is the only mobile

10 Aspects of the discussion in this section are being further developed by F. Flatters and R. Boadway on the economic basis of different forms of federal-provincial fiscal arrangements. For analyses of different aspects of regional resource allocation effects of these arrangements see Flatters, Henderson, and Mieszkoswki (1974) and Boadway and Flatters (1979).

factor of production, efficient resource allocation requires that labour be divided between the two regions in such a way that reallocation of one worker in either direction cannot increase the value of combined output. To a close approximation a market-determined allocation of the labour force will achieve that. With the assumption that for any firm - and hence for the aggregate of firms in each region - each additional worker will contribute less to output than did the previous worker (i.e., the assumption of diminishing marginal productivity), profit-maximizing firms will employ workers up to the point where the last one hired produces just sufficient additional output to cover his additional cost, i.e., the wage rate. If workers are mobile enough, the wage rate across firms and regions will be equalized as will the product generated in any firm or region by a marginal worker. Hence reallocation cannot increase total product since the output loss in a declining firm will be exactly offset by the increase in output in the one that receives the additional worker.

This is illustrated in Figure 3 where L_{Alta} represents the aggregated labour demand schedules of firms in Alberta drawn with respect to the left-hand vertical axis, and L_{Ont} the same for Ontario drawn with respect to the right-hand vertical axis. Both regions' demands for labour are thus declining functions of the relevant wage rates. (For the moment ignore the dashed line L'_{Alta}.) The horizontal distance O_{Alta} O_{Ont} represents the total labour force to be divided between Alberta and Ontario. Under our assumptions the efficient market equilibrum is at E_0 with common wage W_0 and employment of O_{Alta} L_0 in Alberta and O_{Ont} L_0 in Ontario.[11]

Now consider a movement towards parity, which increases the dollar price of the output of the oil-producing region Alberta, thus shifting up its demand for labour schedule to the dashed line L'_{Alta}. In the new equilibrum at E_1 the common wage is increased to W_1 and labour in the amount of L_0L_1 has migrated from Ontario to Alberta.[12] This increase in

11 Of course this initial situation depicted at E_0 is only a rough and oversimplified characterization: many forces cause market-determined wages to differ, high and changing unemployment is an important phenomenon, and so on. However, it nevertheless provides a useful framework for analysing efficiency.

12 The analysis ignores the productivity effects in Ontario of increases in the price of energy and disregards the longer-run adjustments, which would involve investment responses. As our discussant Kevin Clinton points out, we also have confused movements to parity with

wages reflects a fall in profitability in Ontario manufacturing, and the associated decline in output and employment are a form of de-industrialization. While efficiency conditions alone indicate expansion of economic activity in Alberta at the expense of Ontario, our contention is that these adjustments would be quite modest. Conventional oil production of course requires very little labour input, and while the synthetic production in the oil sands is more labour- (and capital-) intensive, there is no argument here for relocation of the manufacturing sector.

However, in Canada these resource flows will be further complicated by existing fiscal-federal arrangements. Most of the relevant information has been presented elsewhere and in particular was quite thoroughly discussed in connection with the excellent papers by Courchene and Hartle in OEC (1980). The two most important facts are: first, oil and gas in Alberta are, in effect, the property of the provincial government and, under current leasing and royalty arrangements, a large share of oil and gas revenues accrues collectively to the residents of Alberta through their provincial government; and secondly, under the current fiscal arrangements increases in provincial resource revenues in Alberta automatically cause large increases in federal equalization payments to 'have-not' provinces (excluding Ontario); these are financed out of general federal revenues and hence can be allocated by provinces, at least approximately, according to each province's share of federal tax collections.

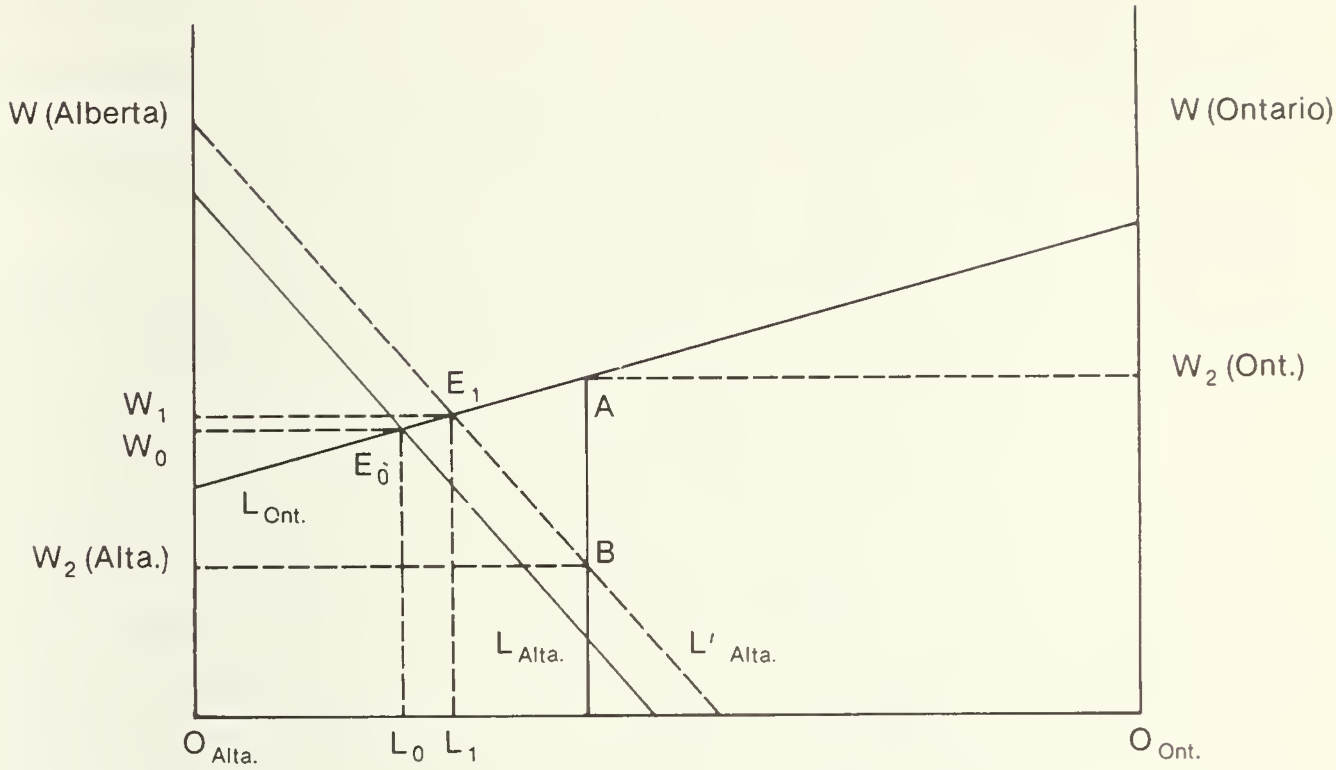
Consider the implications of an increase in oil prices in the light of these two institutional factors. As a result of the first described above, residents of Alberta are in effect paid something in excess of their marginal products - call the excess the 'fiscal benefit'. In the extreme, if all resource revenues accrued to the provincial government and if resources were the only factor of production other than labour, workers would be receiving their average product in Alberta. In Ontario, on the other hand, since resource revenues are unimportant, workers can be thought of as being paid their marginal product.[13] With free interprovincial migration

---

world oil price shocks by ignoring the initial gap between domestic and world prices. See however, our comments below.

13 Note that we have assumed away all functions of the public sector other than the collection of resource revenues. See Flatters, Henderson, and Mieszkowski (1974) for a discussion of the complications of public expenditures at the provincial level in this context.

Figure 3
Parity with Alberta — Ontario labour market integration.



of labour, workers will move between Alberta and Ontario until the marginal product of labor in the latter is equal to the marginal product of labour plus the fiscal benefit in the former. Since, as argued above, economic efficiency requires that the marginal product of labour be equated between regions, there will be some economic waste under this system. However, so long as resource revenues are not very large, the waste will not be very great either. Now the effect of large increases in resource revenues in Alberta becomes obvious. They will cause large increases in the total return to labour in that province without having much effect on its marginal product. This in turn will induce a large flow of migrants to Alberta, and thus open up a much wider gap between the marginal products of labour in the two provinces. The economic waste might be enormous.

This is illustrated in Figure 3 where the net fiscal benefit accruing to residents of Alberta is the distance AB. Labour in the amount L_0L_2 then

migrates to Alberta, at which point the wage in Ontario W_2(Ont) exceeds that in Alberta W_2(Alta) - by the net fiscal benefit.[14] The efficiency loss on this account is measured by the triangle E_1 AB and is thus directly related to the size of the net fiscal benefit. In our opinion this efficiency loss swamps the gain, discussed below by Kevin Clinton, that results from reducing the gap between the domestic and world prices; for the latter to be important, the direct migration effects of the price increase would have to be much larger than we believe them to be.

Now consider the implications of the equalization formula, which essentially uses federal funds to raise selected provincial revenues to the national per-capita average. According to Courchene's (1976) excellent summary, the effect of an increase in Alberta's resource revenues is to increase the revenue deficiencies of the 'have-not' provinces and hence to increase their equalization payments from the federal government. Since oil and gas revenues are concentrated in Alberta and Saskatchewan their effect on equalization payments is potentially very large, and measures have been introduced to reduce that effect. Ontario has, in effect, been prohibited from being designated a 'have-not' province even though she is very poor in terms of energy sources and revenues. Furthermore, since Ontario is by far the largest single source of federal revenues, and Alberta is relatively small in this respect, Ontario bears a much greater share of the increased equalization costs than Alberta.[15] Taking our two important institutional features together, therefore, we summarize the effects of an oil price increase as follows. First, the provincial ownership of the resources makes Alberta a much more attractive place to live than Ontario; secondly, the equalization formula provides a similar incentive in

14 Since the first draft of this paper was written our attention has been drawn to a similar argument made in a recent paper by Helliwell (1980) and we have benefited from reading that paper. Note also the possibility that under the current system the wage in Alberta will fall, thus increasing the 'rents' accruing to owners (mostly foreign) as opposed to the 'competitive' case where wages rise, thus capturing some of the rents for Canadian workers.

15 We assume here and in the following discussion that increased equalization payments are financed through higher federal taxes rather than a higher federal deficit. This is simply for expositional convenience and does not affect the main point of the argument, unless one were willing to argue that the interregional burden of the federal debt is greatly different from that of current federal taxes. So long as an individual's federal tax payments, present or future, do not depend upon his province of residence our argument is unaffected.

favour of the 'have-not' provinces relative to Ontario.[16] Assuming that increases in oil prices do not have an appreciable effect on relative marginal products of labour between Ontario, Alberta, and the have-not provinces, we conclude that under current resource ownership rights and federal-provincial fiscal arrangements any increases in domestic oil prices will increase the inefficiency in the regional allocation of resources (labour) in Canada.

To give some idea of the possible magnitude of these incentives we present in Table 3 some of Courchene's estimates of the fiscal effects in each province of a $1 increase in the domestic price of oil and an accompanying increase in gas prices of 14.65¢ per thousand cubic feet (85 per cent of the heat-equivalent oil price rise). Prices of other energy sources are assumed to remain unchanged. The first row shows the increase in royalties accruing to governments in the producing provinces, the second shows the resulting change in equalization payments to the have-not provinces, and the third shows the concomitant increase in federal tax collections in each province to finance the additional equalization payments. The final rows show the net effect of these three items in each province, both total and per capita dollar amounts.[17] While the typical resident of Ontario loses $3.39 for each dollar increase in oil prices, the fiscal effect on the residents of all other provinces is a net gain, ranging from $5.90 in Quebec to about $6.75 in the Atlantic provinces and Manitoba, $7.12 in BC, $18.72 in Saskatchewan, and $123.73 in Alberta. For a family of four, therefore, each dollar increase in domestic oil prices creates a net fiscal incentive of $41 per year in favour of Newfoundland relative to Ontario or $508 per year in favour of Alberta relative to Ontario. A $10 increase, which is what we have witnessed since 1973 creates incentives of ten times these amounts. A move to parity would also involve a change in the price of oil of a similar magnitude and hence

16 The fiscal arrangements induce migration elsewhere than to Alberta, thus reducing the horizontal axis (See Figure 3) and exascerbating the de-industrialization.

17 Note that these figures are not intended as a measure of the total effect of Confederation on interprovincial revenue flows, even for energy alone. They do not include, for example, the enormous implicit subsidy from Alberta to the oil-consuming provinces arising from the two-price system. Of course the change induced by parity is to reduce this subsidy, thus at the margin also benefiting Alberta at the expense of Ontario.

TABLE 3
Selected fiscal impact of $1/barrel rise in the price of energy[a]

	Nfld	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC	Total
Royalties for prod-prov. $ million)						0.9	1.5	28.0	361.8	28.6	420.8
Resulting equalization ($ million)	5.1	1.0	7.6	6.3	56.2	0	8.3	-6.4	0	0	78.1
Funding for equalization ($ million)	1.1	0.2	1.9	1.5	18.4	30.2	2.8	2.6	9.4	10.0	78.1
Net Balance ($ million)	4.0	0.8	5.7	4.8	37.8	-29.3	7.0	18.2	352.4	18.6	
Net Balance ($ per capita)	6.87	6.40	6.61	6.73	5.90	-3.39	6.70	18.72	123.73	7.12	

a Based on Courchene (1980, 125, Table 5).

also induce large incentives to migration, although not a straight multiple of the bottom row of Table 3. As noted above and documented in Courchene and Helliwell (OEC 1980), measures have been introduced to limit severely the equalization payments induced by further energy price increases. Also Alberta has introduced measures that try to capture some of the rents for current residents (e.g. share distribution schemes) while the nature of the Heritage fund is to defer the migration decision by deferring consumption benefits. Nevertheless the remaining figures are still large, and the distortionary incentives for migration remain as a source of inefficiency.

The symptoms of these economic changes are well illustrated by trends in interprovincial migration in Canada, summarized in Table 4. Several observations are worth noting. First, until the 1970s Ontario was a net recipient of migrants for the whole of this century. The last time Ontario was a net exporter of people was at the end of the last century at the time of the last great westward expansion during the wheat boom. Now, once again, in the 1970s, Ontario had a net population loss through migration. Secondly, for the first time since 1881 at least, the Atlantic region in the 1970s became a net recipient of migrants. Thirdly, Alberta has gone through various alterations in its migration patterns, but once again in the early 1970s it was becoming a significant net recipient of migrants. An examination of regional employment trends would tell a similar story. Comparing the five-year periods immediately before and after 1973 we see that while the rate of employment growth fell in the Atlantic region, Quebec, Ontario, and British Columbia, it increased by more than 50 per cent in Alberta.

Further, we note that if the argument of the earlier part of this section is correct, these migration figures represent just the tip of the iceberg since the substantial incentives to migrate generated by parity have not yet occurred. We do not have an econometric model of this process, and we certainly do not claim to have a complete explanation of it. However, we would argue that oil and gas prices combined with current royalty and equalization arrangements have played an important role.

Although the domestic price of oil has risen a great deal since 1973, it is still well below the present world price. Policies to raise the domestic price to world levels under current fiscal arrangements can be expected to have further important effects on interprovincial resource allocation in

TABLE 4

Net interprovincial migration (thousands)

	Ont	Que	Atlantic*	Man. & Sask	Alta	BC
1881-90	- 84	-132	-101	n.a.	n.a.	+ 37
91-1900	-144	-121	- 89	n.a.	n.a.	+ 58
1901-10	+ 74	- 29	- 75	+394	+218	+164
11-20	+ 46	- 99	- 76	+102	+ 85	+ 58
21-30	+129	- 10	-123	- 15	+ 22	+101
31-40	+ 75	- 32	- 13	-179	- 35	+ 72
41-50	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
51-60	+685.1	+205.2	- 97.0	- 83.4	+127.2	+240.1
61-66	+ 85.4	- 19.9	- 71.0	- 65.6	- 2.0	+ 77.7
66-70	+150.7	-122.7	- 58.1	-122.1	+ 32.0	+115.0
71-76	- 38.6	- 77.6	+ 30.0	- 67.6	+ 58.6	+ 92.3

* excluding Newfoundland before 1951.

SOURCE: Derived from data in R.W. Boadway and A.G. Green (1979, Tables 1-1 and 1-2)

Canada. Our observations about the interprovincial wealth distribution effects of domestic oil price increases are not at all novel; they were well documented, for instance, in OEC (1980). The same issue has also been well discussed in considerations of differences between the prospects of oil-producing and oil-consuming countries in the world economy. What has not received sufficient emphasis is the fact that, in the national context, where there is a much more factor mobility than at the international level, the interregional resource allocation effects of these changes in wealth distribution can be enormous. Furthermore, in the Canadian case the changes in incentives related to interregional factor movements have very little connection with relative changes in the productivity of these factors in different parts of the country. While we concur with the general view that there are serious problems with the current royalty and federal provincial fiscal arrangements in Canada, we do not base our case on the injustice of the wealth effects of oil price changes. Nor would we argue that the federal government should not be involved in equalization of revenue sources over which it has no direct jurisdiction (see for example Courchene in OEC 1980, 129). Instead we stress the fact that under the current arrangements, oil price increases are likely to lead to tremendous waste in the interprovincial allocation of factors of production.

The crucial problem is to determine how to distribute increases in oil and gas rents without introducing further distortions in the allocation of resources.[18] There are many conceivable solutions to this problem. One would be for the provincial government to agree to collect no additional royalties or lease payments from oil and gas; any additional rents would be 'privatized,' and there would be no way that any Canadian could obtain a share of these rents by changing his province of residence. A second solution would be to set quotas on migration to Alberta; additional rents would accrue to all current residents rather than to the owners of the oil-producing companies as would occur under the first solution. A third solution would be to amend the equalization program so that oil and gas revenues were shared among all Canadians; Ontario would become a recipient province, and residents of Alberta would pay the major share of the net costs. Under the present system, parity would lead to a massive increase in federal government expenditures and tax rates, whereas under a true revenue sharing system it would not.[19] J.S. Dupre in his discussion of Courchene's paper suggested a different approach to the funding of equalization whereby Established Programs Financing (EPF) grants to Alberta would be reduced. The suggestion of several of the conference participants that provincial resource revenues should be taxed by the federal government as if they had accrued directly to the residents of the provinces would be a partial solution to the problem; in particular, they raised the possibility of taxing the Alberta Heritage Fund. Another suggestion, not made at that time, was that the goals of equalization could be accomplished by having federal tax rates vary by province, as is done to some extent now under various regional employment and investment incentive programs. Since governments are going to raise revenues by taxing resource rents, the effect of any of these schemes would be to make the distribution of these rents, through reduced taxes and so on, neutral in its effect on the interprovincial allocation of economic activity. Until this problem is solved, the efficiency gains derived from more

18 While Courchene agrees that the rent distribution problem is crucial, he also argues that 'the system of equalization payments is not the critical issue' OEC (1980, vol. 1, 126). We do not see how the two questions can be considered separately.

19 Helliwell (1980) examines the implications of one such revenue-sharing system.

efficient utilization of oil and gas under efficient (i.e. parity) pricing will be counteracted and quite possibly even exceeded by the additional waste through inefficient interregional resource allocation. While various interest groups will argue over the distributional consequences of different solutions, they all should recognize that under the incentives created by current arrangements many of these rents will be dissipated through wasteful activity and hence enjoyed by none.[20]

Suppose that an agreement were reached or the federal government imposed a new equalization program of the type we have been suggesting, so that oil and gas prices could be increased to world levels, and the publicly collected rent distributed in a neutral fashion. This does not mean that such changes in relative prices would have no effect on the Ontario economy relative to that of Alberta. Such a large change in the domestic terms of trade in favour of Alberta would still lead to a significant shift in wealth and economic activity towards that province. In the next section we turn to a discussion of some of the macroeconomic aspects of that adjustment, while in the final section we touch briefly upon some policies that might facilitate the required adjustment.

'DUTCH AND OTHER 'DE-INDUSTRIALIZATION' DISEASES

Increases in the domestic price of energy influence the competitiveness of the domestic manufacturing sector in two ways. The first is the microeconomic or direct effect of the increased factor cost on output prices, taking into account factor shares, input substitution, and output demand elasticity. The second is due to the macroeconomic consequences in terms of wages, the exchange rate, investment, and other variables that may respond to the energy price change.

On the former issue, Waverman in his contribution to OEC (1980) presents some estimates which suggest that the direct cost effects of oil price parity are quite small. He estimated that a 50 per cent increase in all energy prices may lead to a cost increase ranging from 2 to 5 percent in Ontario manufacturing industries, roughly equivalent to the increases that

20 One should note, of course, that many changes in institutional or legal arrangements that yield large over-all efficiency gains still make at least some groups absolutely worse off. (See Stolper and Samuelson 1949.)

would arise from only a 20 per cent increase in wages. The effect of an increase in just the prices of oil, natural gas, and electricity would be lessened considerably if the price of coal did not rise and there were sufficient substitution possibilities. (Waverman's estimates also did not allow for volume of output and price effects).

While these estimates are very useful, there are no doubt a number of ways in which they can be refined and improved; in particular there is still a need for more disaggregated studies to identify the industries or firms that would be affected most. Just because the average effect is small does not mean that particular productive units will not be rendered uneconomic. But from the perspective of this paper the important thing to note is that his estimates treat wages, the cost of capital, and the cost of intermediate imported goods as constant. This suggests that an understanding of the impact on competitiveness must await the type of macroeconomic analysis outlined below.

Before turning to that macroeconomic discussion it is worth commenting briefly on the implications of the foregoing for the issue of parity. As Canada lags behind most of her trading partners in moving towards world prices, a move to parity should not be seen so much as a reduction in competitiveness as a removal of an export subsidy (see Waverman 1975).[21] Since Canadian manufacturing is essentially a price taker in world markets, this subsidy shows up not so much in reduced prices and increased production but rather, as Helliwell points out in his contribution to this volume, in higher profits to Canadian producers. We conclude therefore that the direct effects on competitiveness provide no arguments for not moving to energy price parity, and so we must look to the macroeconomic adjustment issues.

There are two aspects of the macroeconomic adjustment issue. The first deals with the optimal response to the external supply shock. Judged from the perspective of macroeconomics after World War II, this is a novel issue, for what is in question is the desirable <u>direction</u> for demand management to pursue. The supply shock creates stagflation, and accom-

21 In England we read reports of outrage in Canada at Americans driving across the boarder to buy gasoline after the American energy deregulation of March 1980. We did not however read about outrage at Americans buying any other of our subsidized exports. Perhaps value-added in the filling station industry is too low, or the subsidy in the re-export is too visible.

modation by means of demand management means increasing inflation while anti-inflation demand policy exascerbates unemployment.[22]

From the viewpoint of Ontario and the interests of this conference it is the second aspect of macroeconomic adjustment that is now relevant - the desired speed of moving domestic prices to parity. In OEC (1980) Wilson reports some simulations that compare rapid adjustment (parity in one year) with a slower, control solution. The results reported indicate substantial adverse effects on both output and inflation, the latter strong enough to generate wage acceleration even though unemployment is increased. Consumer prices are moderated in relation to output prices, and substitution generates a surplus on current account. Similar results are reported in the Economic Council of Canada's 16th Annual Report (1979) Two Cheers for the Eighties. The latter however also indicate some of the longer-run production gains that might be expected from efficient pricing. They considered a situation where oil prices jump by 40 per cent in 1979, 25 per cent in 1980 and continue to rise at 7 per cent per annum thereafter. They compare a slow adjustment (parity by 1986) with a rapid one (parity by 1982). Under the latter, inflation will be higher and real wages, output, and employment all lower in the period 1979-82, but in 1982-5 inflation will be lower, and wages, output, and employment higher. While results are not reported, presumably in these simulations the Ontario manufacturing sector was more adversely affected than the economy-wide averages indicate. In this section we turn then to a more detailed consideration of some of the mechanisms by which Ontario will be affected by parity.

As discussed earlier, a number of countries that should have gained directly from the boom in raw materials and energy prices in the 1970s by virtue of being net exporters of these goods have in fact suffered indirectly as a result of problems of macroeconomic adjustment. These countries include the Netherlands, Great Britain, Norway, and Australia.

The general argument is as follows. The 'export boom' (and related induced capital flows) lead to an appreciation of the home currency, i.e. to a fall in the domestic currency price of foreign exchange and of imports. Downward rigidity of nominal wages and of domestic currency

22 This issue has recently been addressed in a thoughtful book by Alan Blinder of Princeton University. OPEC has driven home the fact that the United States too is an open economy.

prices of home output leads to a deterioration in the competitive position of the domestic manufacturing sector. In the Dutch case the resource boom also led to a substantial public sector surplus, which in turn was spent largely in the domestic services sector; this of course caused a further adverse swing in the export sector's terms of trade and also bid up domestic wages, further eroding the competitiveness of Dutch manufacturing.

The cause of the problem is the sluggishness of the adjustment of domestic prices, especially nominal wages. The usual argument proceeds, then, that flexible exchange rates will substitute for wage flexibility and that the de-industrialization will lead to a current account deficit, a currency depreciation, a fall in real wages, and a restoration of domestic competitiveness. The Dutch disease arises, then, when the exchange rate effects of the resource boom dominate those of the de-industrialization, thus breaking the chain of adjustment.[23]

The issue is: could Canada also contract the Dutch disease? Being essentially self-sufficient in energy, Canada has not had any dramatic changes in the exchange rate as a result of the OPEC price rises. Indeed, as we shall argue below, the Canadian dollar was undervalued during the latter part of the 1970s. And while the country as a whole has experienced a substantial change in its terms of trade, Ontario has so far been essentially insulated from this change by the fact that Canadian policy has kept the price of oil below parity. This policy of course has not only benefited Ontario directly by sustaining her terms of trade and suppressing the costs of a major input used in Ontario manufacturing, it has also benefited Ontario indirectly both by its effects on the exchange rate through the current account (see Table 2) and through the distortion caused by current fiscal arrangements discussed in the preceeding section. It seems useful, then, to ask whether Ontario might expect to suffer from the Dutch disease if Canada moves to oil price parity.

The answer to the above question is no. Although the movement to parity would almost certainly lead to a situation where Canada again became a net exporter of crude oil, even if there were large exports of

23 One solution would be to fix the exchange rate and let the boom manifest itself in domestic inflation; as long as the real wage is not rigid full employment can be maintained. For further discussion, see Purvis (1977); we return to issue below.

natural gas, it seems unlikely that the exports would be large enough to create a large current account surplus or a substantial appreciation of the Canadian dollar. Further, as argued above, since parity would involve a Federal budget deficit no boom could expected in the services.[24] Any threats that parity might pose for the health of the Ontario manufacturing sector must come from other aspects of the macroeconomic adjustment process, and it is on these possibilities that we focus in the rest of this section.

The 'competitiveness' of an industry is a term used loosely to describe the relationship between the costs paid to factors used in producing output and the price at which the output can be sold; in international markets where the industry output must sell at a price comparable to output produced abroad, competitiveness involves comparing domestic with foreign production costs. Various theories of international adjustment describe how these costs are brought into line in the long run, so that provided the basic laws of comparative advantage guide the allocation of resources, a country can always find gainful employment for its factors of production. The issue of competitiveness then brings into play the interaction between the short run where the international adjustment process is frustrated and the long run where resource allocation issues prevail.

At present the process of international adjustment occurs mainly in the exchange rate. The exchange rate is a nominal variable, and in the long run we would expect its particular value to be of little significance; a depreciation of the domestic currency can be offset by a proportionate increase in nominal prices and wages with neither adverse nor beneficial effects on resource allocation and competitiveness. However in the shorter run, movements in one of these cannot be expected to be offset by movements in the others, and hence movements in these ratios will reflect movements in the real exchange rate. In Canada, there is a fairly general feeling that wages have fallen in relation both to domestic prices and to foreign wages and prices (owing partly to the exchange rate) so that one might expect a catch-up to ensue, with adverse consequences for competitiveness. See, for example, the discussion in OECD (1979, 46). We

24 The budget deficit arising from the equalization system will to a considerable extent be offset by the reduction in the import subsidy. The wage distortion effect of the equalization system discussed in the previous section has an effect analogous to the services sector boom.

now turn to a more detailed examination of recent movements in wages, prices, and the exchange rate.

Looking first at prices, Table 5 shows that the merchandise terms of trade rose steadily in the early part of the decade until 1974. The ratio of export to import prices then levelled off in the next couple of years, declined steeply in 1977-8, and recovered fairly sharply in 1979. In describing these events, we use the terms 'rise and decline' in preference to the mercantalist terms 'improve and deteriorate' advisedly, because an increase in the terms of trade does not necessarily mean an improvement in the competitiveness of the export sector. To see this, consider a simple supply and demand model determining some particular industry's volume and price of output. An increase in its output price, that is, in its terms of trade, can be caused by either an increase in the demand for its product or by an increase in the costs at which it can produce any given level of output. Clearly the first represents an improvement in the industry's position, while the second constitutes a deterioration. Similarly, for Canada an increase in the terms of trade can represent either a improvement or a deterioration in Canada's position. For Ontario, this relationship is more complicated in that the export price index includes both the price of manufactured exports and the price of raw materials. Hence to evaluate these developments we must look more closely at the determinants of the changes. Fortunately this has recently been done by David Longworth, and we can draw on the results of that study.

Longworth shows that the terms of trade can be explained largely by two factors: the ratio of raw material prices to the prices of manufactures in world markets; and the ratio of Canadian to foreign (i.e. U.S.) wages. The latter rose steadily through 1976; the former rose sharply in the period 1971-3 and fell from 1974-6. They thus reinforced each other, and this led to the sharp rise in the terms of trade in the 1971-4 period; they largely offset each other in the period 1974-6. For the manufacturing sector of course it was the increase in relative labour costs that is of importance, for that explains in part the fall in the ratio of tradeable to non-tradeable goods production (see Longworth 1980, Chart 6), the fall in manufacturing output, and the deterioration of the merchandise trade balance (see Table 1 or Longworth, Chart 4) that occurred over that period. Since 1976, relative labour costs in Canada in relation to the rest of the world have fallen moderately in terms of local currencies; adjusted

TABLE 5
Relative costs, prices, and competitiveness in Canada, 1969-79

	U.S. dollar[a] exchange rate (1)	Effective[b] exchange rate (2)	Merchandise terms of trade (3)	Effective relative unit labour costs (own currency) (4)	Effective[d] relative unit labour cost (adjusted) (5)	Gross real[e] wages paid (6)	Gross real[f] wages earned (7)	PGNE÷CPI (8)
1969	94.5	99.4	-	97.8	97.8	87.1	77.3	88.8
1970	97.5	103.2	-	97.4	99.2	87.8	80.3	89.4
1971	100.8	106.4	90.4	98.7	99.8	94.8	84.6	89.2
1972	102.7	106.0	91.3	101.3	101.4	97.5	88.6	90.4
1973	101.7	101.2	98.4	96.9	98.4	97.1	91.1	93.8
1974	104.3	104.5	104.7	104.1	98.3	95.6	95.0	99.4
1975	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1976	103.2	105.1	101.2	110.4	110.1	103.8	104.0	100.3
1977	95.7	96.7	96.7	101.0	101.3	107.4	106.8	102.1
1978	89.2	86.9	92.5	89.8	86.2	108.1	107.5	99.5
1979	86.8	83.8	98.1	85.9	84.1	107.0	108.3	98.8

SOURCE: Columns 1, 3, 6, 7, 8: Bank of Canada Review; columns 2, 4, 5: International Financial Statistics

a price of U.S. dollar, average noon spot rate
b trade-weighted multilateral exchange rate
c Px/Pm, from seasonally adjusted data
d adjusted for exchange rate changes
e hourly wage, manufacturing, divided by PGNE
f hourly wage, manufacturing, divided by CPI (excluding food)

for the exchange rate they have fallen sharply (see Table 5 or Longworth, Chart 3). These factors together explain the fall in the terms of trade over the period 1976-8.[25]

It is worth looking at the role of relative unit labour costs (RULC) in more detail. Longworth makes effective use of RULC as a measure of competitiveness and as a determinant of the terms of trade. We would like to look at a slightly more complex aspect of the interaction between these variables; in particular we want to suggest RULC as a partial explanation of under- and over-valued currencies and we wish to look at the possibility that there is a reverse causality operating between the terms of trade and RULC.

A different measure of competitiveness used for example by Freedman, (1980) is the divergence of the exchange rate from its purchasing power parity (PPP) value as measured, say, by the ratio of GNE price deflators. Such divergences are substantial and prolonged, although there is a tendency to expect convergence in the long-run. How can they be explained? Such divergences appear to violate the 'law of one price' and therefore are a source of considerable consternation to economists. We would like to suggest one way of looking at this problem.[26] Suppose that commodity prices are, in fact, fairly efficiently arbitraged in respect to traded goods, and furthermore that all goods purchased and consumed in a particular country necessarily involve some domestic value added. In this sense all consumption goods are non-traded; traded goods are only intermediate. Then exchange rates will evolve according to relative consumer good prices adjusted for differences in the relative costs of domestic value added. Using RULC as a proxy for the relative costs of domestic value added, a country with high RULC will then be expected to have a currency appreciation relative to PPP as conventionally measured.

Looking at Table 5 we observe that movements in the own currency RULC (column 4) do indeed tend to mimic those of the exchange-rate-adjusted RULC (column 5) indicating less than complete exchange rate

25 Note that the rise in the terms of trade that occurred early in the decade was associated with a deterioration in the position of the manufacturing sector whereas the later fall in the terms of trade corresponded to an improvement.

26 This section draws on work in progress by Ronald W. Jones and D. Purvis entitled 'Notes on "apparent" discrepancies from PPP: the phenomena of "over" and "under" valued currencies.'

adjustment to such changes in RULC. To a lesser extent movements in column (4) also mimic movements in the effective exchange rate. The period 1970-5 was one of rising labour costs in Canada relative to the United States simultaneous with an appreciating Canadian dollar while the post-1976 experience has been reversed. On a broader international comparison, the United States has had a weak currency and has also become a low-wage country relative to the 1960s while such strong-currency countries as the UK and West Germany have been high-wage countries.[27] There is then some reason to expect that the evolution of RULC will influence the evolution of the exchange rate so as to reinforce the direct effects on the competitiveness of the domestic export sector, thus increasing the importance of RULC.

Turning to the role of the terms of trade, we note that by definition import prices are weighted more heavily in calculations of consumer price indexes than producer indexes and that export prices are weighted less heavily. This is illustrated in columns (6) and (7) of Table 5 where we distinguish real wages paid by firms from those received by households. The former are calculated by dividing nominal wages by the GNE deflator, which includes export prices but not import prices; the latter are arrived at by deflating by the consumer price index (excluding food). During the period of rising terms of trade from 1970 to 1974, real wages paid fell relative to real wages received; the converse is true for the period 1976-8 when the terms of trade fell. These relative real wage movements just reflect movements in the ratio of the two price indexes, shown in column (8), which in turn just mimic the terms of trade. Accordingly, the movements shown are simply a consequence of definitions.

But if participants in the labour market are aware of these asymmetries in real wage calculation, their ensuing behaviour will lead to a direct link between the terms of trade and the level of economic activity operating through the wage rate.[28] This phenomenon is implicit in most current discussions of 'real wage resistance' in open economies. The argument is that a foreign inflation or a currency depreciation that leads to an increase in the domestic price of imports will set off an increase in

27 This discussion of course begs the question of whether the United States is a low-wage country because the U.S. dollar is under-valued.

28 This argument and some of its implications for the operation of a flexible exchange rate are developed in D. Purvis (1979).

nominal wages as workers try to protect their real wages. To the extent that the domestic export sector prices do not rise proportionately this will reduce profitability in that sector and lead to a reduction in employment and output.

To what extent does this happen in Canada? In a recent paper Michael Bruno and Jeffery Sachs have estimated a supply of manufacturing output equation for a number of countries in the period 1962-76 using a framework consistent with the one outlined above. Their results for Canada show that the supply of manufacturing output has an elasticity of 0.458 with respect to the terms of trade while with respect to relative imported input prices and real consumer wages the elasticities are -0.33 and -2.33 respectively. These are fairly well determined with t-values of 1.66, 3.46, and 2.42 respectively; together with some time dummies, they explain about 70 per cent of the variation in output supply during the period. While these estimates are regarded by the authors themselves as only preliminary they do suggest that the phenomena we have been describing may be occurring in the Canadian labour market and the manufacturing sector of Ontario.

Other commentators, notably Tom Wilson and Len Waverman in OEC (1980) have shown the importance of wage and exchange rate adjustments for the Ontario manufacturing sector. The preceeding discussion confirms that view and elaborates on some of the mechanisms by which such adjustments might operate. Let us now look more closely at what we might expect in the eventuality of a move to parity.

As explained above, establishing parity should lead to a net external surplus in oil and perhaps a slight currency appreciation. This direct effect should be small enough that we should not expect a de-industrialization of the Dutch type to follow. But will the adjustments in the labour market tend to resist or offset this nominal appreciation? Will we expect also a real appreciation or loss in competitiveness in the sense of an increase in the real wage rate facing producers? Unfortunately, the answer seems to be yes.

The move to parity, and it is important to recall that this involves a rise in domestic energy costs relative to foreign, will raise unit costs in Canada. While these direct increases will be relatively small (cf. the earlier discussion of Waverman's estimates) the PPP-related argument above suggests that the increased unit costs will lead to a further appreciation at

least in the short run. On these grounds then the initial appreciation will be reinforced.

One might hope that the appreciation will lead to a moderation of nominal wage claims, but there is little room for optimism here. First, as we have emphasized above regional adjustments will put upward pressure on real wages in Ontario, and these forces will be exasperated by the distortions introduced by current fiscal federal arrangements. Second, as Waverman's numbers show, energy-related expenditures are a significant fraction of household consumption so that the evidence cited earlier in support of real wage resistance suggests that the increases in energy costs will be accompanied by increases in nominal wages.[29] Further, establishment of parity should lead to an increase in the terms of trade but one that is associated with a deterioration in the position of the manufacturing sector. These last two comments of course reflect the fact that the real wage faced by Ontario employers rises relative to the real wage received by workers. The net effect of these adjustments will be a decrease in competitiveness in Ontario, both in terms of RULC and in terms of normal unit costs.

Our analysis in this section thus reinforces our previous conclusion that establishment of oil price parity would lead to a resource shift from Ontario to Alberta. It is worth examining the role that macroeconomic policy might play in this adjustment process. As we saw, the new equilibrium involves a real appreciation in the sense of higher wages and prices in the manufacturing sector in relation to imported goods and also, of course, a higher relative price of energy-intensive goods. One 'solution' would be to accommodate these relative price increases by accelerating monetary growth and in effect fixing the exchange rate. This policy would involve substantial inflation and would in the long run be frustrated as what is called for is a real appreciation; in our opinion it would be a repetition of the mistake made in 1973. The problem is really one of microeconomic labour market adjustment, and it seems extremely inefficient to use a blunt macroeconomic policy such as inflationary monetary expansion to facilitate that adjustment. It would be preferable, in our view, to maintain the present monetary policy of the Bank of Canada of allowing the dollar to appreciate, and to consider such microeconomic

29 This in turn suggests that some combination of Waverman's simulations 2 and 3 is likely to be relevant.

policies as wage subsidies, adjustment assistance payments, and, indeed, equalization payments to Ontario, to aid the required adjustment.

CONCLUDING REMARKS

As the foregoing sections have argued, the establishment of oil price parity will create some 'de-industrialization', which will be manifested in some shrinking of the manufacturing sector in Ontario. We provide no estimates of the magnitudes involved; although we argue that under existing fiscal arrangements the amount of de-industrialization to be expected will be greater than the efficient amount we do not wish to argue that under ideal conditions the shifts would be negligible. Furthermore it is not likely that the real wage increases induced by the regional resource flows will be immediately offset by exchange rate changes, and therefore a real appreciation will ensue. The problems of adjusting to this new situation will be substantial, and there is room for an enormous amount of work to consider various ways of easing the adjustment burden. But the costs of adjusting are no reason for not adjusting nor are they ultimately reasons for not moving to parity. For Canada as whole, and for Ontario in particular, the burdens of these adjustments are trivial compared to the long-run adjustments we would all be making in the absence of our natural resource endowment. Despite problems with current federal arrangements Ontario is clearly better off by virtue of confederation with Alberta than she would otherwise be.

Changes in relative prices generally call forth changes in the allocation of resources. If Canada had no oil- or gas-producing regions (or if Ontario were a separate country), the large increases in the prices of these products would require significant reductions in real wages and returns to other factors of production and most probably higher rates of unemployment in Ontario as the province's traditional manufacturing sectors struggled to remain competitive. However, because of endowments of oil and gas in Alberta, Canada has not had to suffer nearly so large a deterioration in her terms of trade as most other industrialized countries.[30]

30 In fact, under energy parity (i.e. after elimination of the oil export tax/import subsidy program) Canada would probably cease to be a net importer of oil. If we became a net exporter the unhindered impact of OPEC would be to improve Canada's terms of trade. This indeed was our situation in 1973-4, as shown in Table 2 above.

The presence of Alberta's riches has permitted real wages to remain relatively high; instead of adjustment through real wages and unemployment, the equilibrium size of Ontario (and hence of Canada's manufacturing sector) has fallen in relation to Alberta. Many special interests have taken this to be a sign of weakness in the Canadian economy: one hears stories about the declining competitiveness of the Canadian manufacturing sector in the world economy and special pleas for an 'industrial strategy' or a 'science policy' for Canada, and we witness federal and provincial governments making large expenditures to induce firms to locate or expand in their jurisdictions.

Such arguments and actions are fundamentally misguided. While particular industries or regions may suffer because of changes in world oil prices, the Canadian economy and the individuals in it need not suffer. Without Alberta's riches the residents of Ontario would suffer real losses from oil price increases. However, as Canadians they are free to move and otherwise take advantage of new and emerging opportunities. It might be argued, of course, that transitional adjustment costs might be large, especially for workers displaced from industries or regions that are especially hard bit. If this were so, adjustment assistance payments would be called for. However, the size of the payments that would be required is an empirical question. The studies of which we are aware suggest that the adjustment costs, in terms of unemployment and loss of income, are surprisingly small.[31] Other types of adjustment assistance are discussed elsewhere in this volume; see especially the discussion by Hartle and the Wonnacotts of 'industrial strategy' proposals and John Whalley's discussion of various aspects of adjustment to trade liberalization.[32] Nevertheless, there is an obvious need for studies of specific industries.

To attempt to shield the Canadian economy from these changes in resource allocation by maintaining oil prices at artificially low levels would be no less foolish and wasteful than to induce the greatly exaggerated changes that would occur if we were to move to parity under current royalty and federal provincial arrangements.

31 See, for instance, the paper by Jenkins et al. (1978).

32 This latter was also the subject of a recent conference at MIT sponsored by the National Bureau of Economic Research, proceedings of which will be forthcoming in a volume edited by Jogdish Blagwati.

REFERENCES

Artus, Jacques R. and John H. Young (1979) 'Fixed and flexible exchange rates: a renewal of the debate.' IMF Staff Papers 26, 654-98

Bank of Canada Review various issues

Bank for International Settlements (1979) Annual Report

Blinder, Alan (1979) Government Policy and the Great Stagflation (New York: Academic Press)

Boadway, R.W. and F. Flatters (1979) 'The efficiency basis for regional employment policy' (unpublished)

Boadway, R.W. and A.G. Green (1979) 'The economic implications of migration to Newfoundland.' Mimeo.

Bruno, M. and J. Sachs (1979) Macroeconomic Adjustment with Import Price Shocks: Real and Monetary Aspects. Seminar paper No. 118, Institute for International Economic Studies, University of Stockholm

Courchene, T.J. (1976) Money, Inflation, and the Bank of Canada: An Analysis of Canadian Monetary Policy from 1970 to Early 1975 (Montreal C.D. Howe Research Institute)

Economic Council of Canada (1979) 16th Annual Report, Two Cheers for the Eighties (Ottawa)

Flatters, F., J.V. Henderson, and P. Mieszkowski (1974) 'Public goods, efficiency, and regional fiscal equalization.' Journal of Public Economics 3, 99-112

Freedman, Charles (1980) 'The Canadian dollar, 1971-76.' In R. Wirick and D. Purvis (eds), Issues in Canadian Public Policy II (Kingston: Institute for Economic Research, Queen's University)

Helliwell, J. (1980) 'The distribution of energy revenues within Canada: functional or factional federalism?' UBC Programme in National Resource Economics Paper No. 48

Jenkins, G., G. Glenday, J. Evans, and C. Montmarquette (1978) 'Trade adjustment assistance: the costs of adjustment and policy proposals.' Mimeo (June)

Longworth, David (1980) 'The terms of trade: the Canadian experience in the 1970's.' Bank of Canada Review 1980, 13-25

OECD (1979) Economic Outlook December 1979 (Paris)

Ontario Economic Council (1980) Energy Policies for the 1980s: An Economic Analysis (Toronto)

Purvis, Douglas D. (1977) 'The exchange rate regime and economic policy. Canadian Public Policy 3, 205-18

- (1979) 'Wage responsiveness and the insulation properties of a flexible exchange rate.' In Assar Lindbeck (ed.) Inflation and Employment in Open Economics (Amsterdam: North Holland)

Stolper, W. and P.A. Samuelson (1941) 'Protection and real wages.' Review of Economic Studies 9, 58-73

Waverman, L. (1975) 'The two-price system in energy: subsidies forgotten.' Canadian Public Policy 1, 76-88

Kevin Clinton

There are at least four important themes covered in this extensive survey: monetary policy and resource allocation, Canada's international competitiveness, the problem of de-industrialisation, and the welfare analysis of a domestic oil price increase. My comments concern those four topics.

Purvis and Flatters argue that monetary policy should not be made more expansionary in an attempt to ease the adjustment to real shocks in the economy such as the rapid increase in the relative price of oil. It is refreshing to read a paper that recognizes the very limited influence that the central bank can have on the allocation of real resources. Recommendations have recently emerged from various quarters urging that as part of an over-all industrial strategy monetary policy, in particular exchange rate management, should be attuned to objectives that pertain to the structure of real output.

It is worth elaborating on the author's argument. The unfeasibility of directing central bank policy towards such goals is a direct consequence of the fact that its instruments are nominal rather than real. This is well illustrated in the discussion of the options for exchange rate management posed by a resource boom that improves Canada's terms of trade. Purvis and Flatters point out that the choice lies between two poles. The exchange rate can be defended by means of an expansionary monetary policy, which might initially take the form of official purchases of foreign exchange. In this case the increase in the U.S. dollar price of raw materials is directly transmitted to the domestic economy. Or domestic monetary targets can be retained such that the improved terms of trade are reflected in an appreciation of the Canadian dollar. In the final analysis, no real variables need be significantly affected by the choice. In both cases the real exchange rate (i.e. the observed rate adjusted for differential price change at home and abroad) appreciates, but in the first case this is achieved by a higher price level rather than an increased nominal rate. In both cases therefore, the competitiveness of the domestic manufacturing industry (as opposed to resource-based industry) may be adversely affected. But the second option has the disadvantage of a

The views I present here are mine alone. They are not necessarily shared by the Bank of Canada.

higher rate of inflation.

A rise in the world prices for energy and other resources in which Canada is well endowed can pose the problem for Ontario, which is relatively specialized in manufacturing, that manufacturing costs increase relative to those in the rest of the world. This will not be avoided by holding down the Canadian dollar in exchange markets. In this case it is a more rapid rate of inflation that erodes competitiveness. It is therefore not in the long-run interests of Ontario industry in such circumstances to press for deliberate policies to lower the exchange rate.

The inability to affect the real exchange rate in the long run is just one aspect of the inability of monetary policy to direct the course of real variables. For, suppose the central bank could exert systematic control over the real rate (the relevant time horizon to affect the allocation of resources is years, not months). There is no evidence that this would aid an industrial strategy designed to shift resources into manufacturing. A lower real exchange value for the Canadian dollar would increase the price of tradeable goods in general relative to non-tradeable goods. It would tend to stimulate output in both extractive and manufacturing industries, and would not need to induce a switch from the former to the latter. The relative price change that is required to swing resources from extractive industries towards manufacturing is an increase in the relative price of manufacturing output, not a depreciation. The evidence since 1976 with a real depreciation of 20 per cent or so suggests that the position of resource-based products improved at least as strongly as that of manufacturers.

These observations are also relevant to the discussion of the 'Dutch disease,' which is potentially a serious problem for Canada. The loss of competitiveness in Canadian manufacturing in the mid-1970s stemmed from a real appreciation of the exchange rate. The nominal rate was fairly stable, but our inflation was significantly higher than abroad. That this could occur was due in large part to increased natural resource prices. Purvis and Flatters point to the recovery of the merchandise trade balance to deny the immediacy of the problem, but that is simply not relevant. Proper evidence would include, say, the growth output of end products in the economy.[1] In any event, there may not be anything that governments

1 A discussion along these lines is contained in Charles Freedman and

can usefully achieve by intervening. So even without sharing the authors' optimism, I take no exception with their policy conclusions. The costs of re-orienting macroeconomic policy and of intervening selectively by means of discriminatory taxes, trade controls, and so on are likely to exceed the benefits.

The authors' explanation of deviations from purchasing power parity in terms of relative unit labour costs is tautological, and leads to an invalid inference. By definition, high relative unit labour costs are the product of a high exchange rate or high costs in domestic currency or both. There is no predictive content to the observed positive correlations, and they cannot be used as empirical support for Purvis and Flatters' argument, which apparently inverses the conventional argument that rapid domestic wage inflation tends to cause the exchange rate to fall.

There can be no doubt that the costs for Ontario of a movement to world oil prices would be high, especially under the present system of equalization payments. From a national point of view, Tom Wilson has argued that under existing fiscal arrangements the efficiency gains to be attained by pricing oil domestically at its opportunity cost (the world price) are outweighed by the resulting increased payments to foreign oil companies. Purvis and Flatters introduce the novel idea that provincial ownership of oil resources causes an additional distortion. In their view this distortion is serious enough already (as evidenced by provincial migration patterns) and would be exacerbated by a movement to world oil prices.

The argument is that labour is attracted to Alberta by the inducement of the lower taxes and the share in the Alberta Heritage Savings Fund that are acquired by residence in that province. In comparison with Ontario there is an inflow of labour, which pushes down the real wage paid by firms. Hence the marginal product of labour becomes less in Alberta than Ontario, whereas an efficient national allocation of resources calls for equality. An increase in the domestic oil price augments provincial rents from resource ownership and enhances the costs of the dis-

---

David Longworth, 'Some aspects of the Canadian experience with floating exchange rates,' Conference on Macroeconomics Under Flexible Exchange Rates, Madrid, September 1979.

tortion. In the authors' opinion these costs outweigh the efficiency gains of equating domestic with world prices.

To my mind, Purvis and Flatters make too much of this. First, their argument concentrates on efficiency in production and ignores the improved efficiency in consumption habits to be gained by having consumers confronted with an oil price closer to the social opportunity cost. Secondly, as long as the Canadian price remains below the world price, provincial resource ownership may well be an aid to the attainment of a 'second best' solution rather than an impediment. Without the additional incentive to migration, and with the price paid to Alberta producers below the social opportunity costs, the private marginal product of labour in Alberta will be less than its social marginal product. Thus, there would be a less than optimal amount of resources devoted to exploration for, and extraction of, energy supplies. Provincial resource ownership provides some offset to the price distortion.

Thirdly, Purvis and Flatters' conclusion is heavily dependent on their empirical judgement that interprovincial labour mobility is high in response to the incentives offered by provincial resource ownership. There is little evidence to support this judgement. Whatever may happen in the future, the price increases for energy seen so far (which have been substantial) have not as yet brought about the allocative distortion specified by the authors. I might mention three developments in the 1970s. First, wages rose more rapidly in Alberta than in Ontario and are now higher in many industries in Alberta. Secondly, employment grew 2 3/4 times as fast in Alberta as in Ontario, whereas population growth grew only 1 1/2 times as fast. Thirdly, the unemployment rate fell in Alberta from 5.1 to 3.9 per cent and rose in Ontario from 4.4. to 6.5 per cent.

These facts contradict the Purvis-Flatters hypothesis. According to their hypothesis, population (not just labour) is attracted to Alberta and wage rates are forced down relative to Ontario. To the extent that wage rates adjust slowly, unemployment should rise in Alberta relative to Ontario.

Another view that is consistent with the facts is that the primary spur to increased migration has been from real productivity gains in Alberta (arising from the increased value of its energy production). Labour has been drawn primarily by higher real wages and job opportunities; full provincial coffers have been a minor incentive. The authors'

opinion that this would be very much changed in a movement towards parity to the world oil price is in need of substantiation. In the absence of some convincing empirical evidence, I do not think that the new points raised by Purvis and Flatters regarding a movement towards parity should preoccupy us.

Discussion

QUESTION: At the risk of appearing to represent a special interest group, or showing my misinterpretation of what the conference is about, I would like to raise one matter, and that is the highly theoretical content of the discussion. Presumably we are all concerned about the economy of Ontario, but what is more important is what we are going to do about it, both government and the private sector. I have heard only one passing reference to the real world so far in this conference, and there are manufacturers here, people in mining, agriculture, and so on, and it seems to me that it would be useful if the authors and discussants would introduce some comments about policies and programs that might practically be introduced in the decade to solve some of our very nasty problems.

DONALD TAYLOR: Thank you, I think that view is shared by others in the audience. Would you care to comment on the question of some specific policies that might be appropriate in Ontario's case?

KEVIN CLINTON: I think if you look back to Doug Hartle's comments this morning a good message there is that you can very often find problems in the economy, but that doesn't mean necessarily that the government can do anything useful about them, and the track record seems rather to be the reverse. In my comments earlier I was trying to say that there are a lot of issues where we shouldn't leap in and try to do something.

DONALD TAYLOR: It appears you will have to wait until later this afternoon to get some answers to your questions.

DOUGLAS PURVIS: I would like to thank Kevin Clinton for reading the

paper so carefully. I was glad to hear that somebody in the central bank, although he was speaking for himself, shares my view on the role of monetary policy.

As to resources and de-industrialization, I don't think we disagree on that: we were saying that the current account recovery, even with the most optimistic forecast, would be very small. I shall simply say that there is a point to that, that we in fact started from the position of competitive equilibrium rather than from one where there was the other distortion you introduced; you are absolutely right - there are the two distortions, and they could offset each other, and so it is an empirical issue. Most of the empirical evidence you presented though was not really relevent, it seemed to me, because we are arguing what would happpen when we moved to parity and we haven't done that yet, so we don't have any evidence.

I am not quite sure how to respond to you question, sir: I think this is exactly the kind of analysis that is required in order for us to be able to do something about the real world.

NOTES

NOTES

Ontario Economic Council Papers

Special Research Reports
1980 Series

Energy Policies for the 1980s: an economic analysis

These publications are available from the Publications Centre,
5th Floor, 880 Bay Street, Toronto, Ontario M7A 1N8